National Bank of Serbia

August 2019

INFLATION REPORT

August

2019

INFLATION REPORT

NATIONAL BANK OF SERBIA
Belgrade, Kralja Petra 12,
Tel: +381 11 3027-100

Belgrade, Nemanjina 17,
Tel: +381 11 333-8000

www.nbs.rs
Number of copies: 60
ISSN 1820-9394

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 an 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 at its meeting of 8 August 2019.

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

ABBREVIATIONS

bp – basis point
CPI – Consumer Price Index
EBRD – European Bank for Reconstruction and Development
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
FOMC – Federal Open Market Committee
GDP – gross domestic product
GVA – gross value added
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
LHS – left hand scale
mn – million
NAVA – non-agricultural value added
NPL – non-performing loan
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
RMCP – real marginal cost of processed food production
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

Though economic growth in some of the advanced economies (USA, euro area) exceeded expectations in Q1, all relevant international institutions revised down their global growth prospects for this year due to the weaker dynamics in international trade and investment, noting that growth will pick up gradually over the coming years. As for the euro area, our key trade partner, slower-paced growth is projected for the remainder of the year, while the positive impact of macroeconomic fundamentals at home will prevail in the medium term. As assessed by the relevant international institutions, economic growth in Central and Southeast European countries, which are also our important trade partners, will remain relatively high owing to rising domestic demand propped by positive labour market developments. Against the backdrop of global slowdown and somewhat poorer prospects going forward, as well as the absence of any major inflationary pressures, the ECB announced additional monetary stimulus, while the Fed trimmed its policy rate by 25 bp in July, as had been expected, thus helping to maintain favourable global financial conditions. The announcements of monetary stimulus by leading central banks resulted in a lower risk premium for the majority of emerging economies as of May, with the fall in Serbia's risk premium being the most pronounced relative to other countries in the region, thus indicating that the fall was triggered by both global and domestic factors. In July, Serbia's risk premium fell below 60 bp, its lowest level on record.

As regards the international environment, the period since the last Report was marked by less favourable global growth prospects due to additional protectionist measures, low inflationary pressures and the increasing certainty of a new cycle of monetary policy easing by leading central banks.

After reaching this year's maximum of 3.1% in April, y-o-y inflation in Serbia decelerated in accordance with expectations and measured 1.5% in June. Such inflation movements were mainly a result of the lower contribution of the prices of fresh vegetables with the onset of a new agricultural season – namely, their contribution contracted from 1.6 pp in March and April to 0.35 pp in June. Also, the inflation slowdown was more pronounced than what we stated in our short-term forecast in the May Inflation Report, given that in Q2 vegetable prices fell more than usual for the season, while petroleum products prices rose less than we expected. Low inflation is still attributable to low cost-push pressures, as well as pressures on the demand side, which is also suggested by the core inflation's range of 1.4–1.5% y-o-y in Q2. In addition, one- and two-year ahead inflation expectations of the financial and corporate sectors are anchored around the target. The fact that their inflation expectations are

In accordance with expectations and NBS announcements, y-o-y inflation slowed down as of May, mostly in response to the lower contribution of vegetable prices with the onset of a new agricultural season. Core inflation remained low and stable in an environment of positive labour market developments – in Q2 it ranged between 1.4% and 1.5%.

anchored signals the credibility of monetary policy and higher resilience to potential negative effects of developments abroad.

The decision on the key policy rate cut was made in consideration of expectations that inflation will remain within the target tolerance band in the coming period, most likely in the lower part of the target range for the remainder of the year and in 2020, as well as in light of the sustainability of the results achieved in terms of narrowing the fiscal and external imbalances, and measures of monetary policy easing by leading central banks.

The NBS trimmed its key policy rate in July and August, each time by 25 bp, to 2.5% – its new lowest level in the inflation targeting regime – whereby the NBS provided an additional boost to economic growth. In making the decision, the NBS Executive Board took into account the expected inflation movement within the bounds of the target band in the coming period, most likely below the central midpoint, for the remainder of the year and in 2020, as well as the sustainability of the results achieved in terms of narrowing the fiscal and external imbalances, and announcements of monetary policy accommodation, followed by actual measures by leading central banks. The Executive Board expects these accommodative measures by leading central banks to have a positive effect on conditions in the international financial market and capital flows to emerging economies, including Serbia. Moreover, the Executive Board underlined that the resilience of the Serbian economy to negative impacts from the international environment has increased thanks to more favourable macroeconomic indicators and prospects for the coming period.

Lending activity exerts a considerable contribution to stable and sustainable economic growth, not posing a risk to the maintenance of price or financial stability.

Owing to past monetary policy easing, the persistently low interest rates in the international money market, a lower country risk premium and increased interbank competition, financial conditions in the private sector remained favourable. Coupled with the effects of economic growth, as well as rising wages and employment, this contributed to stable y-o-y growth in lending, which measured 9.4% in June, excluding the exchange rate effects. An almost equal boost also came from the corporate and household sectors. The loan structure remained favourable, notably in the corporate sector, where investment loans took up a dominant position as of May, while in June they reached a level 20% higher than a year ago. In addition to continued NPL resolution efforts, growth in lending still contributes to a further decline in the share of NPLs in total loans – their share dropped to 5.2% in June, the lowest level on record and 17.2 pp lower than at the time when the NPL Resolution Strategy was adopted.

Growth in economic activity and corporate profitability, as well as positive labour market developments, are conducive to the continuation of favourable fiscal movements, while a significant increase in government capital expenditures and the rise in public sector wages and pensions represent sources for financing investment and consumption, though not in the extent that would

Favourable fiscal trends continued in 2019, as evidenced by the fiscal surplus of RSD 17.3 bn in six months and the primary surplus of RSD 87.3 bn, recorded against the backdrop of much higher government capital expenditure and increased outlays for wages and pensions. Positive fiscal trends are underpinned by economic growth, increased corporate profitability and positive labour

market trends. Observed over a longer term, fiscal discipline and balanced public finances helped bring public debt within a sustainable framework – the share of central government public debt in projected GDP equalled 51.4% at end-June (vs. 70% at end-2015 and 53.8% at end-2018). The currency and the refinancing risks are being reduced thanks to the government opting mostly for borrowing at home, by issuing long-term dinar securities, the maturing and early payment of a part of the debt under eurobond issues in dollars, and lower interest rates on borrowing. The share of public debt in GDP is expected to remain sustainable and on the decline in the coming period as well.

cause major inflationary pressures and disrupt the downward trajectory of public debt.

Owing to the rise in production and export capacities, which reflects past investment, as well as agricultural inventories from the previous season, goods export in H1 2019 continued to record a relatively high growth rate of 8.5% y-o-y. As in the previous period, goods import rose (10.2% y-o-y) on the back of an increased import of raw materials and equipment to meet the needs of the ongoing investment cycle, which played the key role in the widening of the trade deficit. Amid rising consumer demand, a higher import of consumable goods was also recorded. However, considering that the imported equipment will push up the export capacities of the Serbian economy, the share of the current account deficit in GDP is likely to narrow in the medium run. For several years already, the surplus in the services trade was facilitated by the high rates of services export (16.7% y-o-y in the first six months of 2019), which are comparably among the most dynamic in the region owing to macroeconomic stabilisation and improved conditions for doing business and the development of export-oriented service companies. A positive impact on the current account came from lower expenditures under FDI, notably in conditions of the considerably higher FDI inflow in the past several years owing to the fact that investors are willing to reinvest increasing shares of their profit in Serbia's economy. In contrast, the 100% tariffs on products delivered to Kosovo and Metohija acted in the opposite direction.

This year's balance of payments trends are under the impact of the country's investment cycle and the slowdown in external demand.

This year, as in the past four years, the current account deficit is fully covered by the net FDI inflow which equalled EUR 1.8 bn in the first six months of the year. The EUR 1.9 bn FDI inflow (9.0% of estimated GDP) was diversified across projects and for quite some time now it has been channelled mainly to the tradable sectors. Together with the downward trajectory of the share of public debt in GDP, this is providing support to the country's external sustainability and economic growth on sustainable grounds. Foreign investors' increased interest

As in the past four years, this year's current account deficit is fully covered by the net FDI inflow, and we expect it to remain so in the coming period as well.

in securities in the Serbian market resulted in a net inflow of EUR 152.4 mn from portfolio investment. The heightened interest of foreign investors in Serbia's macroeconomic perspective was confirmed in the international market in June, when the ten-year eurobond was issued under the most favourable terms for Serbia as yet. The rate on this bond (1.619%) is also among the lowest rates for ten-year eurobonds issued by countries in the region, including those whose credit rating is higher than Serbia's. All of the funds obtained by the eurobond issuance (EUR 1.0 bn) were used for early purchase of a portion of dollar bonds maturing in 2020 and 2021, which were issued in the international financial market at much higher interest rates. These movements in external trade and financial transactions resulted in a EUR 884.3 mn rise in FX reserves – to EUR 12.1 bn at end-June, which further fortified our economy's resilience to external shocks.

For 19 quarters straight, economic activity has recorded a positive growth rate and it has accelerated relative to Q1.

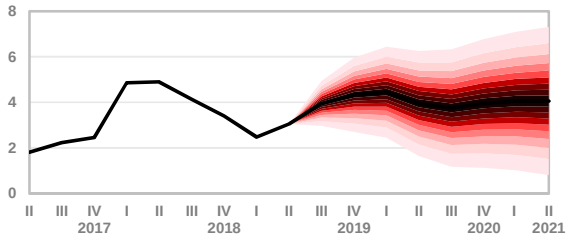
According to our assessment, y-o-y GDP growth equalled 3.1% in Q2 and was faster than in a quarter earlier. We estimate that this can be attributed to the stepped-up activity in the construction sector, as well as the continued growth in the services sectors. In contrast to this, agricultural and industrial production recorded a decline. After dropping at end-2018, industrial production has been on the mend at a slower rate than anticipated owing to the still dampened external demand, overhaul in the oil and chemical industries, as well as the weaker performance of the food industry, which feels the negative effects of the tariffs on the goods delivered to Kosovo and Metohija. On the expenditure side, the GDP rise in Q2 was also driven by investment, thanks to the continued implementation of infrastructure projects, improved business climate and favourable sources of financing for the private sector, as well as household consumption, which reflects the rise in wages and employment, and lower costs of borrowing. At the quarterly level, GDP growth in s-a terms sped up in Q2 and is estimated at 1.5%, meaning that economic activity has been on the rise for 19 consecutive quarters.

Our GDP growth projection for 2019 remains unchanged (3.5%), while in the medium term we expect growth to accelerate to around 4% and to be led by investment, exports and a sustainable rise in household consumption.

We have kept our GDP growth projection for 2019 at 3.5%. As in the previous projection, we expect GDP growth to be fully led by domestic demand, whose positive contribution increased as a result of more favourable investment trends and final consumption since the start of the year. On the other hand, due to lower external demand, net exports gave a negative contribution. On the production side, we expect to see continued growth in the services sectors and construction, and a recovery in industrial production on account of the waning of the effects of one-off factors and a strong FDI inflow, while agriculture will most

likely give a negative contribution due to the base effect. In the medium term, we expect GDP growth to speed up to around 4% and to be led by investment, exports and a sustainable rise in household consumption. Medium-term risks to the GDP projection are assessed as symmetric, while in the short-term, i.e. during 2019, the risks emanating from the international environment are estimated as skewed to the downside and those from the domestic environment to the upside.

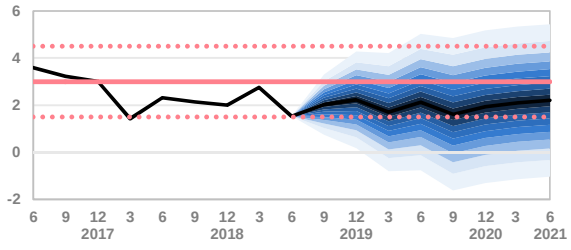
GDP growth projection
(y-o-y rates, in %)



Under the August projection as well, y-o-y inflation will continue to move within the target tolerance band until the end of the projection horizon, most likely in the lower part of the target band. The low inflation projection is still based on low cost-push pressures and the rise in aggregate demand on sustainable grounds. Relative to the projection in our May *Inflation Report*, the new medium-term inflation projection is lower for the remainder of the year, and then somewhat higher until the end of the projection horizon. The main reason for the lower inflation projection until end-2019 lies in the lower than expected y-o-y increase in vegetable prices in May and in June, whose base effect in the coming year will act in the opposite direction. Uncertainty surrounding the inflation projection is associated primarily with movements in international commodity and financial markets, and administered price growth to an extent. Taken together, the risks to the projection are judged to be symmetric.

Y-o-y inflation will remain in the target tolerance band until the end of the projection horizon – most likely in the lower part of the target band.

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



Monetary policy decisions in the coming period will continue to depend on the assessment of the effects of past monetary policy easing on inflation movements going forward, and the impact of other domestic and external factors. Given that the key risks to the projection still largely emanate from the international environment, the NBS will continue to carefully monitor and analyse trends in the international commodity and financial markets, and assess their impact on the local economy. As so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium run, at the same time preserving financial stability and contributing to sustainable economic growth and preservation of macroeconomic stability.

It is assessed that key risks in the period ahead will emanate from the international environment and, as such, they may affect the monetary policy stance.

II Monetary policy since the May *Report*

In the period since the May Inflation Report, the NBS trimmed the key policy rate to 2.5%, its new lowest level in the inflation targeting regime, thus providing additional support to lending and economic growth. The NBS Executive Board's decision to trim the key policy rate was primarily motivated by inflation kept firmly under control for the sixth year in a row, the sustainability of the results achieved in narrowing fiscal and external imbalances, and the increasingly clear signals hinting at monetary policy accommodation, followed by actual measures of leading central banks.

In the period since the May Inflation Report, at its June meeting, the NBS Executive Board kept the key policy rate unchanged, only to trim it by 25 bp both at its July and August meetings, to 2.5%, its new lowest level in the inflation targeting regime.

In the period May–July, Executive Board decisions were based on the May inflation projection, which forecast that until the end of the projection horizon y-o-y inflation would continue to move within the target band, i.e. most likely in its lower part in the next two years. Furthermore, it was expected that after reaching the target midpoint in April, y-o-y inflation would start to decline only to move close to the lower bound of the target tolerance band during H1 2020 and gradually start returning to the target midpoint.

Same as in the previous projections, the factor expected to play the key role throughout the projection period was the growth in aggregate demand. Besides, the disinflationary pressures on account of past appreciation of the dinar were expected to gradually wane and administered prices to pick up slightly faster than in previous years. On the other hand, the key disinflationary effect in the coming period should stem from the high base in vegetable prices. Uncertainty surrounding the inflation projection relates primarily to movements in the international commodity and financial markets and, to some extent, administered price growth.

Speaking of economic activity, the May projection kept the GDP growth forecast for 2019 unchanged (3.5%), with a slightly altered structure. As in the previous projections, it was expected that economic growth would be fully driven by domestic demand, whereas its increase is expected to be somewhat higher due to more favourable investment and final consumption trends since the start of the year. On the other hand, it was expected that the contribution of net exports would be more negative than in the February projection due to slower growth of the euro area. GDP growth was still expected to pick up in the medium-term, to around 4%, led by investment, exports and household consumption rising on sustainable grounds.

In deciding **to keep the key policy rate at an unchanged level in June**, the Executive Board deliberated amid the crosscurrents of macroeconomic conditions at home, which exerted a favourable impact on economic activity and inflation, and developments in the international environment, which warranted caution.

Caution was mandated mainly due to renewed trade tensions and new protectionist measures between major world economies, fuelling uncertainty in the international commodity and financial markets. Tensions were especially tightened in May and early June, primarily due to the introduction of new tariffs by the USA on the import from China and the announcement of new tariffs on the import from Mexico. New protectionist measures and trade tensions continued to jeopardise business confidence, increasing concerns that it could reflect negatively on investment and economic growth. Although the slackening of global economic growth and inflation caused slower normalisation of the monetary policies of leading central banks – the Fed and ECB, it remained uncertain to what extent the normalisation would diverge from market expectations, which might trigger volatility in global capital flows. Monetary policy decisions of the Executive Board also called for caution over the global oil

price, which was volatile under the impact of many factors – both on the supply- and demand-side.

On the other hand, domestic macroeconomic conditions of implementation of monetary policy remained favourable. In addition to these conditions, the NBS Executive Board's decision **to cut the key policy rate in July to 2.75%** was motivated by ever more certain monetary policy easing of the leading central banks. Inflation was kept firmly at bay for the sixth year in a row and, consistent with Executive Board's announcements, after reaching the target midpoint in April, it is moving in the lower part of the target band. It is expected to continue to move within the target tolerance band in the coming period, probably staying in the lower part of the band. Low inflationary pressures are indicated by still low and stable core inflation, as well as short- and medium-term inflation expectations of the financial and corporate sectors anchored around the inflation target of the NBS.

As assessed by the Executive Board, in the medium term inflation would approach the target midpoint mainly owing to the gradual rise in domestic demand. Namely, economic growth, continuation of positive labour market trends, characterised by the rise in wages and employment and the drop in the unemployment rate will reflect on the further rise in domestic demand. Domestic demand growth has also been supported by NBS's past monetary policy easing through lower interest rates on new dinar loans, and lower costs of repayment of outstanding loans, which reflected positively on household disposable income. The achieved and sustained stability of the financial system and relative stability of the domestic currency, aided by the share of NPLs in total loans, which is at the lowest level on record, opens room for further lending and economic growth. In addition, interest rates on euro-indexed loans are still low, aided by the still strong monetary accommodation by the ECB, as well as by stronger interbank competition and the fall in Serbia's risk premium.

The country's general macroeconomic stability and development prospects were also underpinned by positive fiscal movements. As in the past two years, the consolidated budget has recorded a surplus since the start of the year and the public debt-to-GDP ratio was reduced to 51.4% in June. Also, Serbia replaced a part of its expensive dollar debt by issuing ten-year euro-denominated Eurobonds in the international financial market, at the lowest interest rate, i.e. the best financial conditions that Serbia has ever had in the international market. Higher FDI and portfolio investment inflows indicate the confidence that investors have in the growth sustainability of the Serbian economy. A lower Serbia's risk premium speaks in favour of that – it reached its historical low at end-June and then further dropped to a new minimum in July.

Between the Executive Board's meetings in June and July, global trade tensions eased and news from the international environment were positive – the USA and China renewed talks on their trade relations and the introduction of new tariffs on the import from Mexico was abandoned. The inflow of capital to Serbia on account of portfolio investment was considerably higher, mainly due to the increasingly clear signals from the Fed that it would begin a new monetary policy easing cycle over concerns that weak global economic growth and uncertainty regarding trade policy could jeopardise business confidence and dent investor readiness to invest. Although markets expected that the Fed would narrow its interest rate target range by two or three times by the end of the year, it has not widened it since December 2018. The ECB also signalled clearly that it was willing to do even more if needed. The ECB extended the period during which it would not raise its key interest rates (at least until mid-2020), possibly even further trimming them in the said period. Also, from September, the ECB will start implementing a new, third series of quarterly targeted longer-term refinancing operations (TLTRO III), which will be in effect until March 2021, aimed at preserving banks' favourable credit conditions. The anticipated new cycle of monetary policy easing of the leading central banks should favourably affect the conditions in the international financial market and capital flows to emerging countries, and therefore to Serbia. In addition, the global oil price dipped, and futures suggest that it will move at the current level at end-2019.

Starting from the August inflation projection, the Executive Board **trimmed the key policy rate by 25 basis points to 2.5%**. The Executive Board stressed that, according to its August projection, inflation would probably continue to move in the lower part of the target band until the end of this year and in 2020. The projected low and stable inflation is underpinned by low cost-push pressures and sustainable growth in aggregate demand. Besides favourable macroeconomic conditions of implementation of monetary policy at home, the NBS Executive Board's decision to further cut the key policy rate was motivated by trends in the international environment, mainly the slowdown in global trade and economic growth and monetary policy easing of the

leading central banks. The Executive Board stressed that trends in the international financial and primary commodity markets, especially markets of crude oil and primary agricultural commodities, will continue to be closely monitored and analysed. The Executive Board pointed out that the resilience of the Serbian economy to potential adverse effects from the international environment had increased, owing to more favourable macroeconomic indicators and prospects. As so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium term. Together with maintaining financial stability, this will contribute to sustainable economic growth and strengthen the country's resilience to external uncertainties.

III Inflation movements

Consistent with our expectations and previous announcements, y-o-y inflation has been on its downward path since May, measuring 1.5% in June. Such y-o-y inflation movements were predominantly driven by a significantly lower contribution from fresh vegetables prices, with the onset of the new agricultural season. Low inflationary pressures are indicated by low and stable core inflation (around 1.4% y-o-y in Q2), as well as inflation expectations of the financial and corporate sectors, which were additionally lowered since June, standing below the target midpoint.

The quarterly dynamics of consumer prices was determined by a notable decline in prices of fresh vegetables in May and June, recording lower growth in Q2 than expected in the May Inflation Report. At the quarterly level, prices rose by 0.2%, led by the seasonal rise in the prices of fresh fruit, meat, travel packages, clothes and footwear, as well as higher prices of petroleum products.

Inflation movements in Q2

Consistent with the expectations stated in the May *Report*, after temporarily approaching the target midpoint in April, y-o-y inflation slowed down and measured 1.5% in June. Such y-o-y inflation movements were predominantly driven by a lower contribution from fresh vegetables prices, with the onset of the new agricultural season – from 1.6 pp in March and April to 0.35 pp in June. Compared to our expectations from the May *Inflation Report*, the inflation slowdown was faster than expected, given that during Q2 the prices of vegetables decreased more than seasonally expected, whereas lower global oil prices started to spill over to petroleum products in the domestic market, which at the quarterly level rose less than expected. Low inflation is still underpinned by low cost-push pressures, as well as pressures on the demand side, as indicated by core inflation, which continued to move around the lower bound of the target tolerance band, measuring 1.4% y-o-y in June.

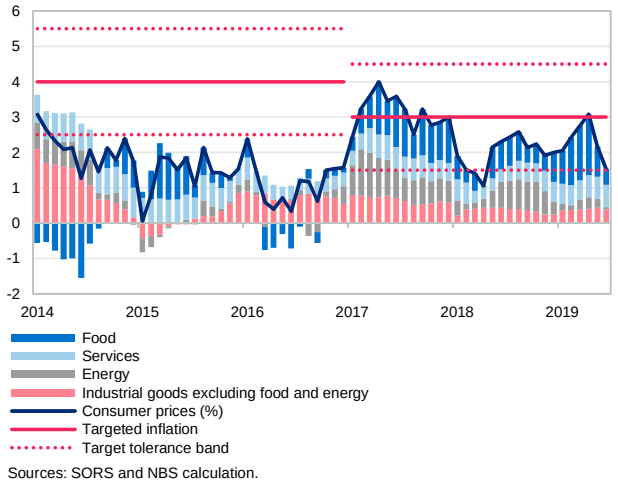
Consumer prices picked up by 0.2% in Q2. Overall, the prices of **food and non-alcoholic beverages** decreased by 1.2% in Q2, led mainly by the cheapening of fresh vegetables, which was sharper than expected, giving a 0.4 pp negative contribution to quarterly inflation. Higher prices of fresh fruit (7.7%) and fresh meat (6.4%) worked in the opposite direction, with 0.1 pp and 0.2 pp contribution, respectively. The prices of **processed food** rose somewhat in Q2 (0.3%, contribution: 0.1 pp), primarily on account of bread and cereal price hikes.

Table III.0.1 **Contribution to y-o-y consumer price growth**
(in pp)

	2019		Difference
	March	June	
Consumer prices (CPI)	2.8	1.5	-1.3
Unprocessed food	1.4	0.3	-1.1
Fruit and vegetables	*1.4*	*0.2*	*-1.2*
Fresh meat	*-0.1*	*0.0*	*0.1*
Processed food	0.2	0.2	0.0
Industrial products excluding food and energy	0.4	0.4	0.0
Energy	0.3	0.1	-0.2
Petroleum products	*0.2*	*0.0*	*-0.2*
Services	0.5	0.6	0.1

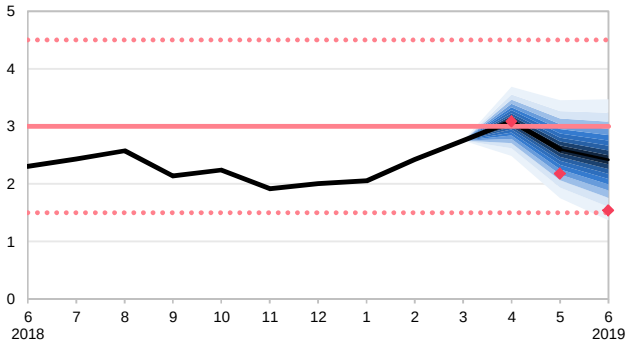
Sources: SORS and NBS calculation.

Chart III.0.1 **Contribution to y-o-y consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

Chart III.0.2 **Short-term inflation projection from May 2019 and actual inflation**
(y-o-y rates, in %)



◆Actual inflation

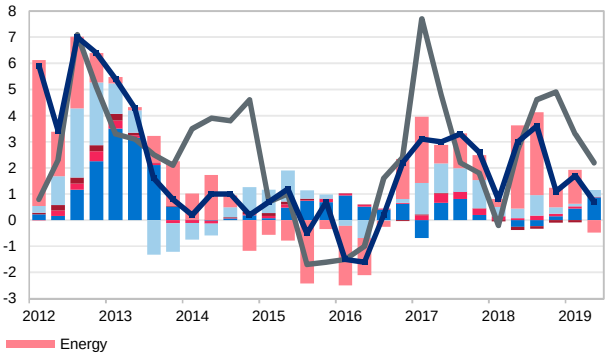
Sources: SORS and NBS calculation.

Table III.0.2 **Growth and contribution of components to consumer price growth in Q2 2019**

	Growth rates (%)	Contribution (pp)
Consumer prices (CPI)	**0.21**	**0.21**
Unprocessed food	-3.96	-0.46
Processed food	0.29	0.06
Industrial products excluding food and energy	0.53	0.15
Energy	0.88	0.13
Services	1.30	0.32
CPI excluding energy, food, alcohol and cigarettes	1.02	0.47
Administered prices	0.10	0.02

Sources: SORS and NBS calculation.

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



Energy
Intermediate goods, except energy
Durable consumer goods
Capital goods
Non-durable consumer goods
Prices of elements and materials in construction (%)
Producer prices (%)

Sources: SORS and NBS calculation.

* Industrial producer prices for the domestic market.

The largest positive contribution to quarterly growth of consumer prices came from **service prices** (1.3%, contribution: 0.3 pp), which was predominantly driven by the seasonal hike in prices of travel packages (28.8%, contribution: 0.2 pp). Rents also rose in Q2 (1.9%), and slightly prices of apartment maintenance and repair services, as well as transportation and catering services, giving a 0.1 pp cumulative contribution to inflation.

Industrial product prices excluding food and energy picked up by 0.5% in Q2 (0.1 pp contribution), driven predominantly by a seasonal hike in the prices of clothes and footwear (2.2%), mobile phones, computers, audio and TV devices (1.6%), each contributing 0.1 pp. In contrast, the prices of vehicles and spare parts fell by 0.1%, as well as the prices of medical and pharmaceutical products. Y-o-y, the price growth in this group was stable since the start of the year, equalling 1.4% in June.

Energy prices increased in Q2 (0.9%, contribution: 0.1 pp), as a result of the prices of **petroleum products** going up in April and May (2.0%). However, in y-o-y terms, energy prices slowed down their growth to 0.4% at end-Q2, due to a fall in petroleum products prices in June (-0.6% y-o-y).

Administered prices almost stagnated in Q2. Y-o-y, the prices edged up by 2.3% in Q2, the same as in the previous quarter.

As opposed to Q1, **the prices within core inflation** (measured by CPI excluding food, energy, alcohol and cigarettes) increased in Q2 (1.0%, contribution: 0.5 pp). The quarterly dynamics of these prices was mainly driven by higher prices of travel packages, clothes and footwear, which is usual for this time of year.

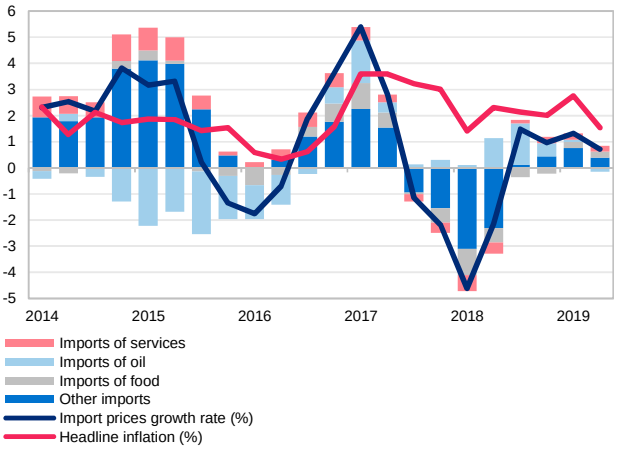
Producer and import prices

Industrial producer prices in the domestic market posted modest growth of 0.1% in Q2, which slowed down their y-o-y growth to 0.7% in June (from 1.7% in March), confirming low cost-push inflationary pressures since the start of 2019. The slowdown in y-o-y producer price growth was driven by the drop in the prices in energy production (first time since September 2016), reflecting a fall in global oil prices. On the other hand, a positive contribution came from the prices of **intermediate goods** (owing to the rise in metal and chemical product prices), and **non-durable consumer** goods (on account of higher costs of food production and beverages). The prices of **capital** and **durable consumer goods** edged up y-o-y, providing a slight contribution to producer price growth

in Q2. Although the prices of **elements and materials incorporated in construction**, which are used to approximate cost-push pressures in this field, rose 1.7% in Q2, their y-o-y growth slowed down to 2.2% in June (from 3.3% in March).

Dinar-denominated import prices[1] **stayed almost unchanged**, which reflected on their y-o-y slowdown to 0.7% on average in Q2 (from 1.3% on average in Q1). This is primarily the result of the fall in global oil prices denominated in the US dollar, which in Q2 were by 8.1% lower on average relative to the same period the year before (contribution: -0.1 pp). Conversely, a positive 0.4 pp contribution, though lesser than in Q1, came from the prices of German exports, which are used to approximate prices of imported equipment and intermediate goods. Working in the same direction, global prices of food expressed in the US dollar rose, as did consumer prices in the euro area, which are used to approximate prices of imported services (each contributed 0.2 pp). Euro's slide vis-à-vis the dollar also affected the pace of the prices of imported goods and services in Q2.

Chart III.0.4 **Contribution of individual components to y-o-y growth rate of import prices in dinars**
(in pp)

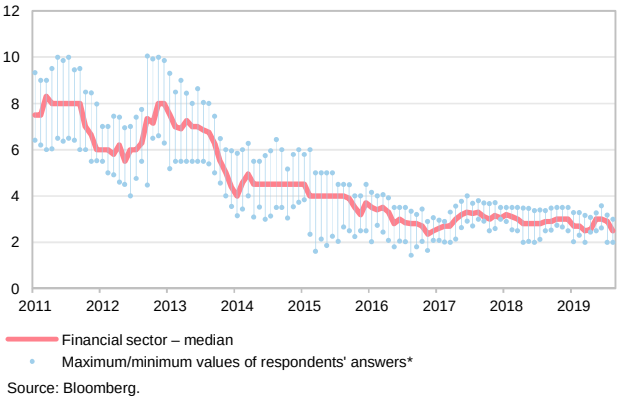


Sources: Destatis, FAO, Bloomberg, Eurostat, SORS and NBS calculation.

Inflation expectations

Besides confirming the credibility of the NBS, anchored inflation expectations enhance the efficiency of monetary policy and strengthen the resilience of the domestic economy to shocks from the international environment. According to the results of the latest surveys, the financial and corporate sectors expect that inflation will remain low and stable in 2020, and in the medium run, within the NBS target tolerance band (3±1.5%).

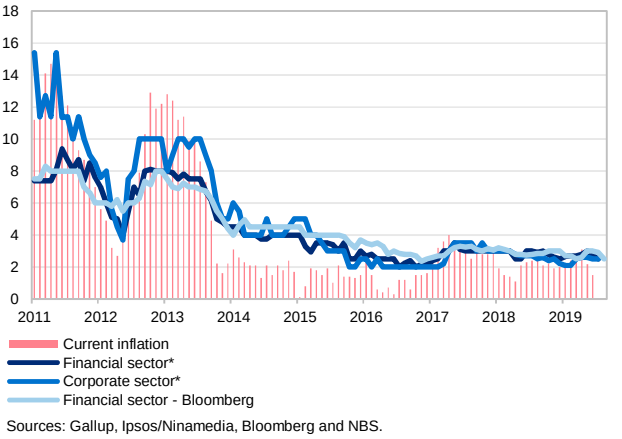
Chart III.0.5 **One-year ahead inflation expectations of the financial sector**
(y-o-y rates, in %)



Source: Bloomberg.
* 10-90 percentile range.

One-year ahead **inflation expectations of the financial sector** have moved close to the target midpoint (3.0%) since early 2019. According to the results of the Ipsos survey, short-term inflation expectations of the financial sector moved in the range of 2.8–3.0% in Q2, only to fall to 2.5% in July. Similarly, the Bloomberg survey results point to similar expectations of the financial sector regarding inflation movements in Q2 2020. After touching 2.6% in April, inflation expectations stood at the target midpoint of 3.0% in May and June, only to drop to 2.9% and 2.5%, respectively, in July and August. Looking at a longer horizon, the financial sector has expected price stability and inflation within the NBS target tolerance

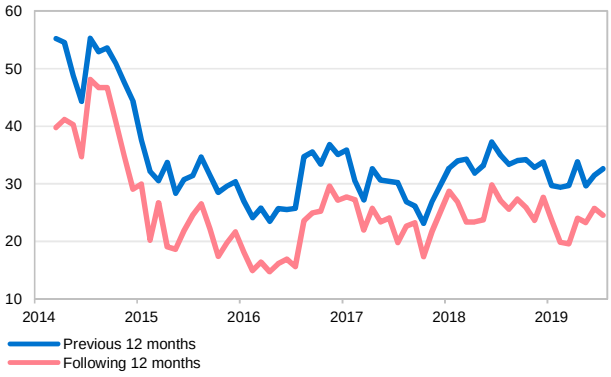
Chart III.0.6 **Current inflation and one-year ahead inflation expectations**
(y-o-y rates, in %)



Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.
* Ipsos and Gallup until December 2014, Ninamedia since December 2014, and Ipsos since January 2018.

[1] The weighted average of the global Brent oil price and food price index (FAO index), euro area consumer prices, and export prices of Germany, one of Serbia's main foreign trade partners, is used as an indicator of import prices.

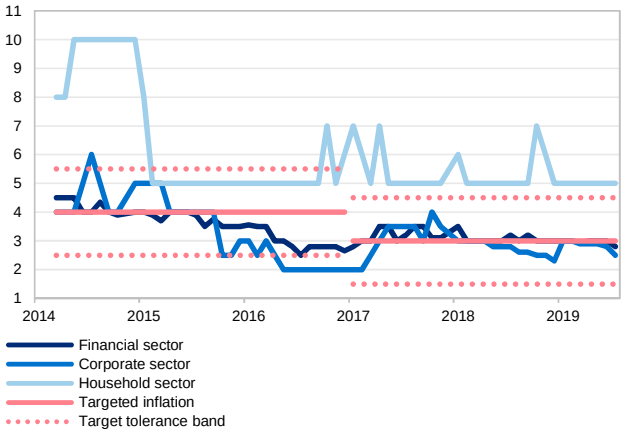
Chart III.0.7 **Household perceived and expected inflation***
(in index points)



Sources: Ipsos/Ninamedia and NBS calculation.

* Ipsos until December 2014, Ninamedia since December 2014, and Ipsos since January 2018.

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



Sources: Ipsos/Ninamedia and NBS.

* Ipsos until December 2014, Ninamedia since December 2014, and Ipsos since January 2018.

band for almost six years now (since October 2013). Anchored inflation expectations are also reflected in the lower dispersion of individual expectations of financial sector representatives, confirming their confidence in measures taken by the NBS.

One-year ahead inflation expectations of corporates moved in the lower part of the target band in Q2. After standing at 2.6% in April and May, they edged down to 2.5% in June, probably under the impact of the deceleration of actual inflation. They stayed at the same level in July. In addition, two thirds of corporates expect that the price of production inputs would not change over the next twelve months, which suggests that corporates expect price stability to be preserved.

One-year ahead inflation expectations of the household sector are typically higher than those of other sectors, ranging between 5.0% and 6.0% in Q2. On the other hand, the results of the qualitative survey of household inflation expectations[2] show that the index of perceived inflation continued to record higher values than the index of expected inflation, indicating that households expect inflation to be lower over the next 12 months than in the past year.

Two-year ahead inflation expectations of the financial sector are anchored within the NBS target tolerance band since their monitoring began (March 2014), standing at the 3.0% target midpoint since October 2018, while declining to 2.8% in July. **Medium-term expectations of corporates** have been falling gradually since early 2019, only to stand at 2.8% at end-Q2 and 2.5% in July. **Two-year ahead inflation expectations of households** have been stable at 5.0%.

[2] For more details on qualitative expectations of households see the February 2016 Inflation Report – Text box 2, p. 15.

IV Inflation determinants

1 Financial market trend

Rising dinar liquidity of banks put a downward pressure on dinar interest rates in Q2, and the continuation of monetary policy easing in July pushed interest rates in the interbank money market further down.

Interest rates

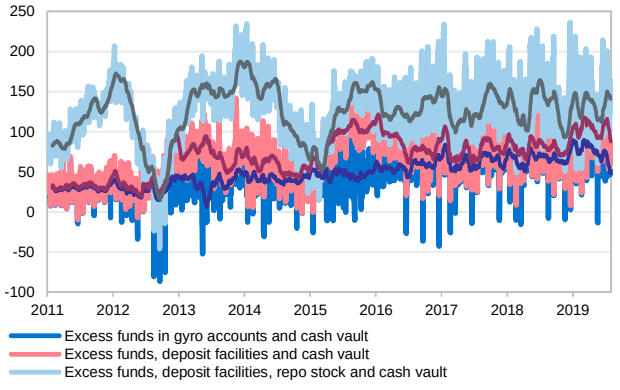
An increase in dinar liquidity in Q2, especially pronounced toward the end of the quarter, extended the downward movement of interest rates in the **interbank money market** and reduced the trading volumes in the overnight money market on average by RSD 0.2 bn, to RSD 3.6 bn.

The average rate on one-week repo operations dropped by 0.17 pp relative to March, to 1.76% at end-June, i.e. almost to the level of the deposit facility rate. BEONIA also went down (by 15 bp relative to March), averaging 1.85% in June. BELIBOR rates of shorter maturities lost 0.1 pp, ranging between 2.2% and 3.1% in June. The NBS's decision to organise additional FX purchase swap auctions in Q2 helped to moderate interest rate volatility in the interbank money market.

July saw the key policy rate trimmed to 2.75%, which spilled over to a further fall in BELIBOR rates of all maturities, moving between 1.8% and 2.6% at the month's end.

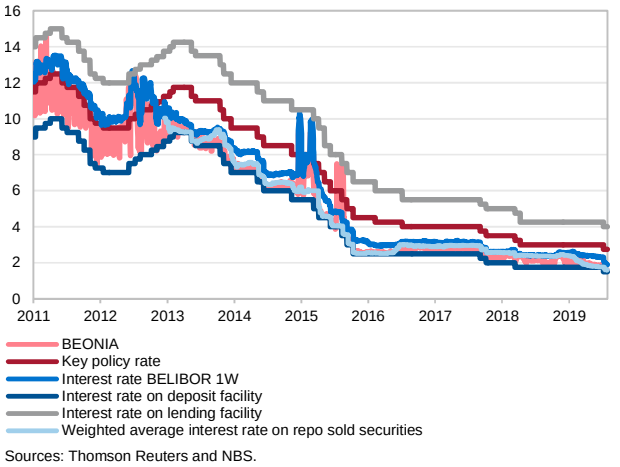
In the **primary market of dinar government securities** the government auctioned benchmark bonds with three- and seven-year maturity, one auction every month. A rise in demand has been evident since May, especially for seven-year bonds, which triggered a fall in the actual auction rates. At end-Q2 they came at 3.4% for three-year maturity and 4.4% for seven-year maturity, declining by 0.3 pp and 0.2 pp respectively relative to Q1. The demand for dinar securities was also spurred by higher interest of non-residents, who bought 68% of the total volume sold since May in the primary market.

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



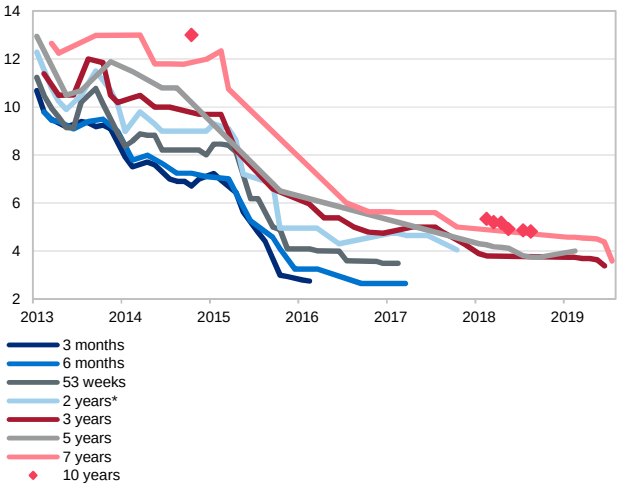
Source: NBS.

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



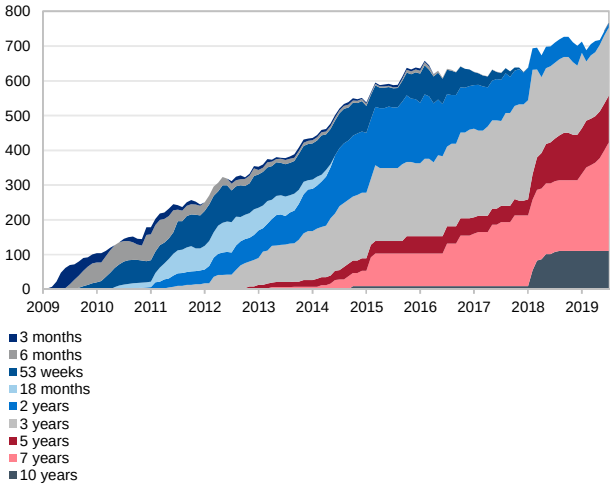
Sources: Thomson Reuters and NBS.

Chart IV.1.3 **Interest rates in the primary market of dinar government securities**
(p.a., in %)



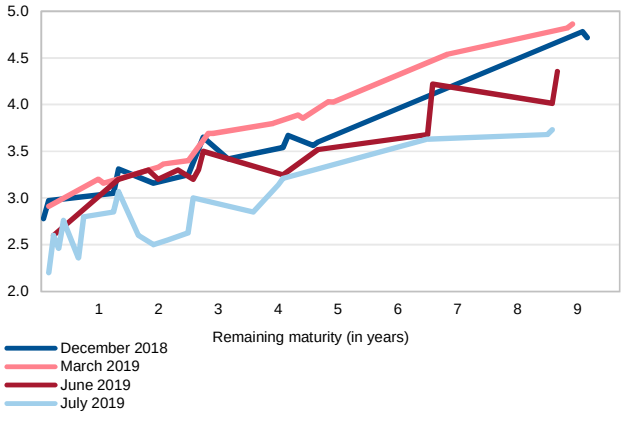
Source: Ministry of Finance.
* Excluding coupon securities with the rate linked to the NBS key policy rate.

Chart IV.1.4 **Stock of sold dinar government securities**
(in RSD bn)



Source: Ministry of Finance.

Chart IV.1.5 **Yield curve in the secondary government securities market**
(average values, p.a., in %)



Source: Central Securities Depository and Clearing House.

Although it planned to sell RSD 56.2 bn worth of securities in Q2, owing to higher demand and lower yield rates offered, the government sold dinar securities in nominal amount of RSD 72.9 bn. As RSD 20.8 bn (nominal amount) worth of securities matured in Q2 and another RSD 15.5 bn were early redeemed in auctions,[3] the total stock of dinar securities sold increased by RSD 36.5 bn to RSD 741.8 bn, with the portion of the sold stock owned by non-residents increasing by RSD 25.2 bn to RSD 234.2 bn.

Positive movements in the primary market of dinar securities extended into July. The government organised one auction of seven-year benchmark bonds in which the demand by far outstripped the planned sales volume (RSD 15 bn), so it sold RSD 23 bn (nominal amount) worth of securities. In tandem with increasing investor readiness to offer much lower yield rates, this brought the interest down by as much as 78 bp, to 3.59%.

In Q2, the government sold euro securities (two-, three- and five-year maturity) in nominal amount of EUR 218.6 mn in the primary market. Yield-to-maturity rates also went down, to 0.84% for two-year maturity, 1.15% for three-year maturity and 1.5% for five-year maturity at end-Q2. As the same period saw the maturing of euro securities worth EUR 341.1 mn nominally, the stock of sold euro securities contracted by EUR 122.5 mn, to EUR 2,784.6 mn in Q2.

Investor confidence in the reforms implemented in the previous years, reflected in the rising interest in Serbian government securities, was also confirmed in the **international financial market**, by a successful eurobond issue. Namely, the government sold eurobonds in nominal amount of EUR 1 bn, at the rate of 1.619% (coupon rate 1.5%)[4].

The **secondary market** saw approximately the same volume of trading in dinar securities as in Q1 (RSD 95 bn), while yield-to-maturity rates declined (up to 0.5 pp relative to March), ranging from 2.6% for the remaining three-month maturity to 4.35% for the remaining nine-year maturity (104 months) in June.

The average interest rate on **new dinar household loans** went further down in Q2, by 0.3 pp to 9.75% in June, its lowest level in the inflation targeting regime. This was

[3] Three-year securities in nominal amount of RSD 10.5 bn (maturing in April 2020) were bought back in April and May at the rates of 3% and 2.9%, respectively, and seven-year securities in nominal amount of RSD 5 bn (maturing in February 2022) were bought back in June, at the rate of 3.5%.

[4] See Text box 1, page 20.

aided by a mild drop in rates on new cash loans, by 0.2 pp to 10.05% in June, and a somewhat sharper fall in rates on other loans, by 0.9 pp to 8.8% in June.

Interest rates on **new dinar corporate loans** recorded a somewhat milder fall since March (0.1 pp), measuring 5.1% in June. In terms of loan category, interest rates on dinar investment loans were the same as in March (5.7%), while interest rates on other non-categorised loans declined, to 4.9% in June. On the other hand, interest rates on current assets loans mildly increased, to 4.9%.

Interest rates on **euro-indexed corporate loans** flatlined from March, measuring 2.8% in June. In the structure of euro-indexed corporate loans, interest rates on investment loans and other non-categorised loans edged down mildly, to 3.0% and 2.5%, respectively, while interest rates on current assets loans increased by 0.1 pp to 2.8% in June.

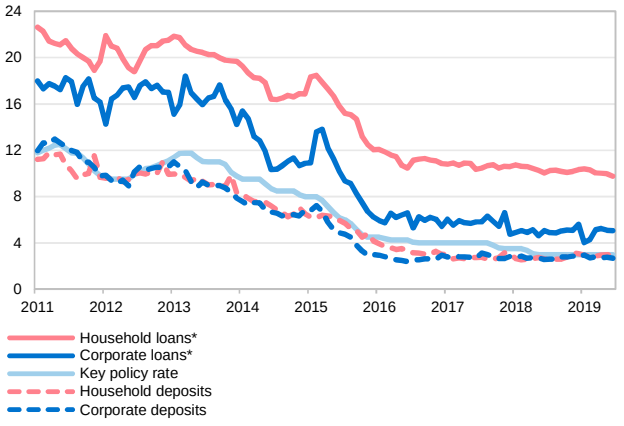
The weighted average rate on **euro-indexed household loans** dropped by 0.8 pp since March, to 3.3% in June. This drop in the interest rate can be put down to a significantly higher share of new euro-indexed housing loans in total euro-indexed household loans, largely reflecting the implementation of the Law on the Conversion of Housing Loans Indexed to Swiss Francs, as these loans generally have lower interest rates compared to loans used for other purposes (3.0% in June).

In Q2, interest rates on **time deposit**s changed negligibly. Thus, rates on dinar household savings edged up slightly (by 0.1 pp to 3.0%), while dropping by 0.2 pp on euro savings, to 0.9% in June. Interest rates on dinar time deposits of corporates dropped marginally (by 0.1 pp to 2.7%), while those on euro time deposits stayed at 0.3%, same as in March.

Risk premium

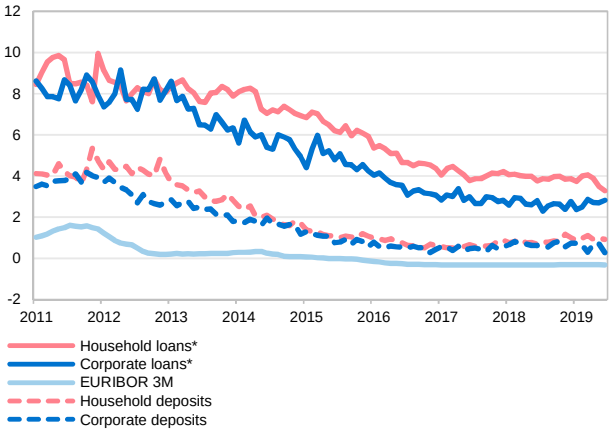
Emerging markets' risk premia rose in the first half of Q2 on the back of heightened global trade tensions and the introduction of new protectionist measures by the world's leading economies, denting the prospects for global economic growth. In the period thereafter, however, investor sentiment improved as leading central banks announced that the pace of their monetary policy normalisation would be slower than previously signalled, i.e. as the expectations that the key central banks would start a new round of easing gathered pace. With late June hints of a possible agreement between the US and China on not introducing additional protectionist measures for the time being, the risk premia of most emerging markets

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



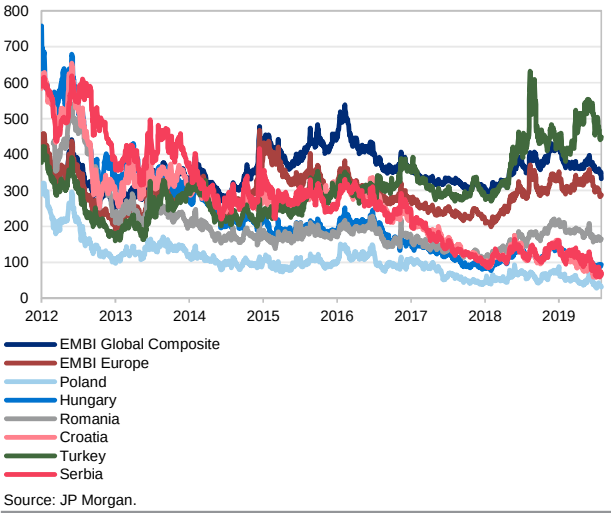
Source: NBS.
* Excluding revolving loans, current account overdrafts and credit card debt.

Chart IV.1.7 **Interest rates on new euro and euro-indexed loans and deposits**
(weighted average values, p.a., in %)



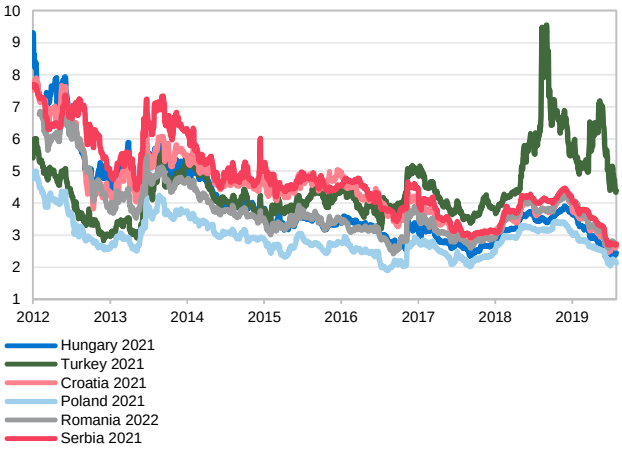
Sources: European Banking Federation and NBS.
* Excluding revolving loans, current account overdrafts and credit card debt.

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



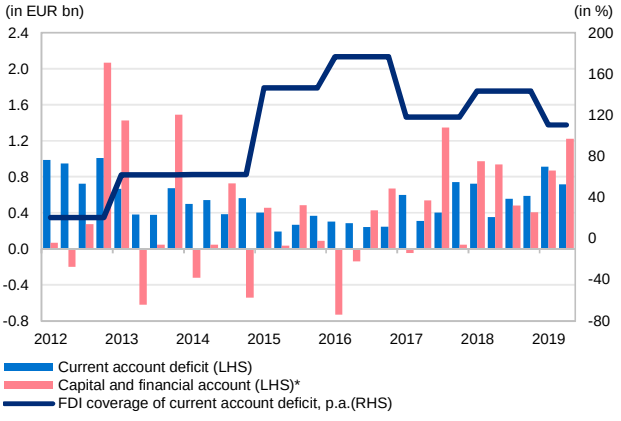
Source: JP Morgan.

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



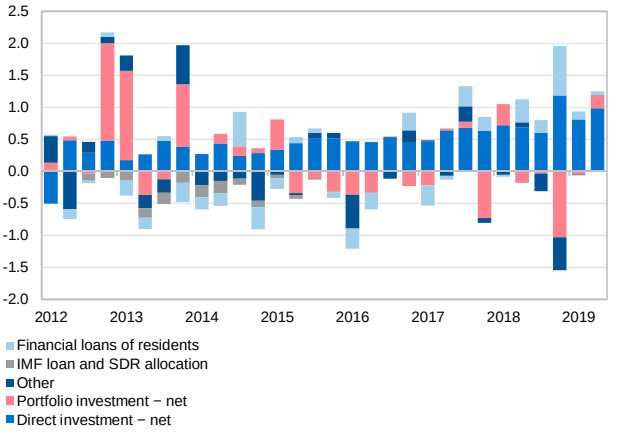
Source: Bloomberg.

Chart IV.1.10 **Current account deficit and net capital inflow**



Source: NBS.
Note: Preliminary data for Q2 2019.
* Excluding changes in NBS FX reserves.

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



Source: NBS.
Note: Preliminary data for Q2 2019.

went down. As a result, EMBI Europe fell by 30 bp from end-Q1 to 301 bp at end-Q2, while EMBI Global, as a composite measure of risk premium, stayed broadly unchanged (down by 7 bp, to 366 bp), mainly due to a sharp rise in Venezuela's risk premium (by 3,643 bp) following the imposition of economic embargo by the US.

The risk premia of all countries in the region declined in Q2, and Serbia's the most – by 42 bp, to 89 bp in late June, indicating that the decline was driven not only by global factors, but also those domestic. In the course of July, Serbia's risk premium plunged to a new minimum (59 bp), staying among the lowest in the region and confirming investors' confidence in favourable macroeconomic prospects and indicating their greater readiness to invest in Serbia.

Furthermore, Fitch Ratings affirmed a stable outlook for Serbia in May, while Standard & Poor's affirmed a positive outlook in June, sending a positive signal to investors.

Foreign capital inflow

The bulk of foreign capital inflow in Q2 was FDI, whose amount was more than sufficient to fully cover the current account deficit. While higher non-resident investment in government securities led to a net inflow of portfolio investment, inflow was registered also on account of government, bank and corporate credit borrowing.

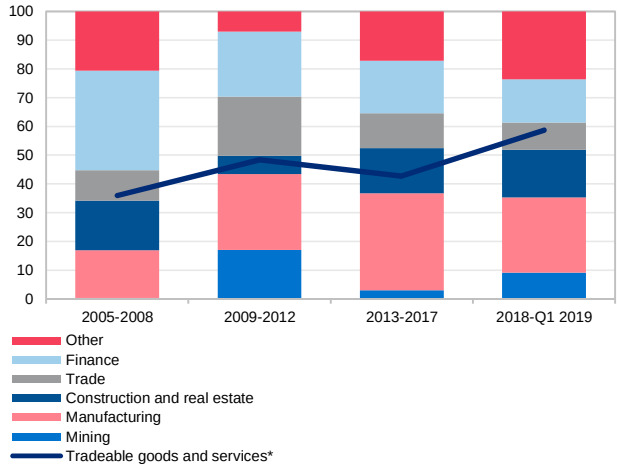
A relatively high net **FDI** inflow extended into Q2. According to preliminary data, it amounted to EUR 986.5 mn. Thus, net capital inflow on these grounds reached almost EUR 1.8 bn in H1, which is 27.7% more than in the same period last year. Investments were widely dispersed across sectors, the largest amounts being channelled to manufacturing (25%), construction (22%), financial industries (16%) and transport (9%). Nearly three fourths came from European countries, while Asian investments accounted for 9% of FDI inflows.

Owing to greater interest of foreign investors in government securities in the domestic market, a net inflow in Q2 was also registered on account of **portfolio investment** (EUR 201.0 mn). Growing confidence of foreign investors came particularly to the fore in June, when after a six-year break, Serbia issued in the international financial market a ten-year eurobond under the most favourable financial conditions so far. The funds raised (EUR 1 bn) were fully used to replace the dollar

debt issued at higher interest rates, i.e. to buy back early a part of dollar bonds falling due in 2020 and 2021.[5]

In Q2, resident liabilities under **financial loans** went up by EUR 63.3 mn net, driven mainly by government borrowing (up by EUR 53.2 mn), and to a degree, net liabilities of banks and corporates under financial loans (up by EUR 6.6 mn and EUR 3.6 mn, respectively).

Chart IV.1.12 **FDI structure by sector**
(in %)



Source: NBS.
Note: Preliminary data for Q1 2019.
* Agriculture, industry, mining, transportation, catering.

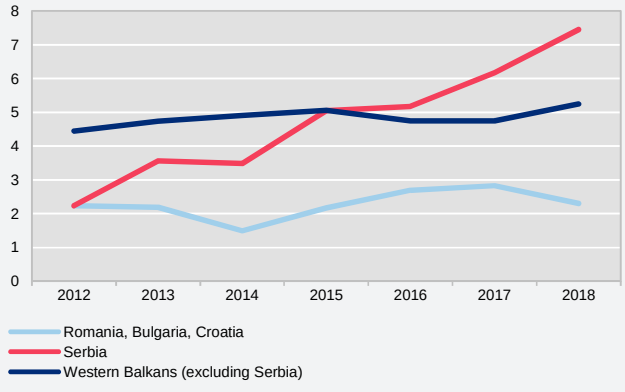
[5] See text box 1, page 20.

Text box 1: Serbia's prospects through the prism of foreign capital inflow

The achieved and preserved macroeconomic stability and the implemented structural reforms have created conditions for sustainable economic growth of Serbia, turning it into an attractive investment destination. Many economic indicators have significantly improved – inflation has been low and stable for six years in a row averaging 2%, public finances have been balanced and public debt brought within sustainable bounds (from end-2015 the share of public debt in GDP fell by more than 20 pp, to 51.4% in June for central government level). External imbalance and the share of external debt in GDP also narrowed considerably (from 73.5% at end-2015, to 62.8% in March this year). Furthermore, financial stability has been preserved and bank financial soundness additionally improved first and foremost owing to successful and sustainable reduction of NPLs to the lowest level on record. Over the past several years Serbia has also been implementing reforms in many areas (labour legislation, planning and construction, investment...), which improved the regulatory framework and provided for a more favourable business and investment environment.

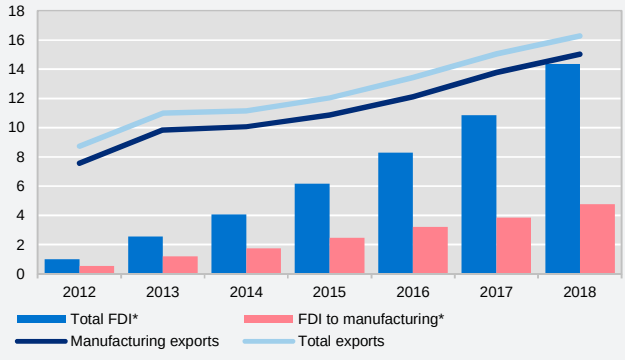
The achieved results in terms of improved business environment are also confirmed by the persistent rise in FDI inflow to Serbia despite the slowdown in global FDI flows in the past couple of years. It is exactly at the time of implementation of intense reforms and macroeconomic stabilisation that Serbia is among the top countries of the region according to the share of net FDI inflows in GDP. In 2015 this share averaged around 6% and in 2018 it reached 7.5%. Looking at the volume of FDI, Serbia has been a leader in the Western Balkans for years now and with a net inflow of EUR 2.4 bn in 2017 and EUR 3.2 bn in 2018 it has joined the group of leading transition economies[1]. Reinvested earnings are rising by the year (around 60% of earnings on average), showing that investors were right to invest in Serbia and to further intensify their presence in our economy. The year 2019 saw the continuation of positive tendencies since FDI inflow reached EUR 1.9 bn in H1, up by 31.0% from the same period last year.

Chart O.1.1 **Net FDI inflow to Serbia and the region**
(in % GDP)



Sources: NBS, websites of central banks and Eurostat, NBS calculation.

Chart O.1.2 **Cumulative FDI to Serbia and exports**
(in EUR bn)



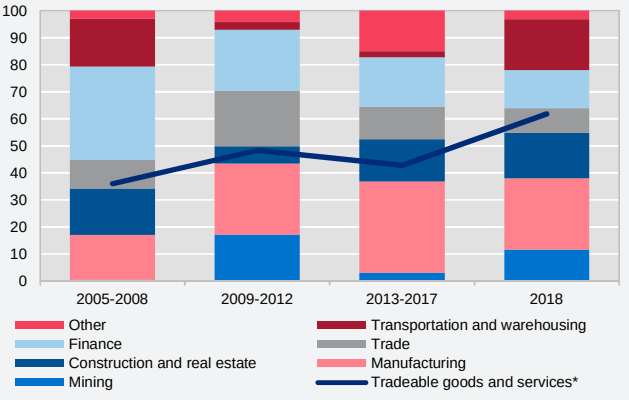
Sources: SORS and NBS calculation.
* Cumulative inflows since 2012.

The FDIs emphasize the sustainability of Serbia's external position on two grounds. First, since 2015 net inflows on this account have more than fully covered the current account deficit which has been at around 5% of GDP in recent years. Second, the ever increasing FDI in tradable sectors (around 62% of inflows in 2018, compared to 36% in the pre-crisis period) will contribute directly to the future improvement in Serbia's external position. Around one third of total inflow has been directed towards manufacturing, mainly in the form of small-scale export-oriented projects and this makes FDI an important contributor to two-digit export

[1] The comparison is based on the data from UNCTAD World Investment Report 2019, where transition economies include those of the Western Balkan countries, Commonwealth of Independent States and Georgia.

growth rates in this branch over the past four years which at the same time increased output and employment on sustainable grounds. In manufacturing, investments are project-diversified, and the greatest amounts went to food industry, production of rubber and plastic products, base metals and metal products and automobile industry. Concerning job creation, IBM Global Location Trends indicate that Serbia has been among the best ranked countries for several years now and since 2017 Serbia has had the highest relative number of jobs (job creation per 1 million persons) created from FDI in the entire world. Rising geographic diversity of FDI sources is another contributor to the sustainability of the country's external position. In addition to increasing investments from the EU, which is the largest investor owing to its geographic proximity and economic relations, the presence of investors from other countries is also on the rise, first and foremost China and United Arab Emirates. As a result, the share of FDI from EU countries dropped from 72% in 2015 to 61% in 2018.

Chart O.1.3 **FDI structure by sector**
(in %)

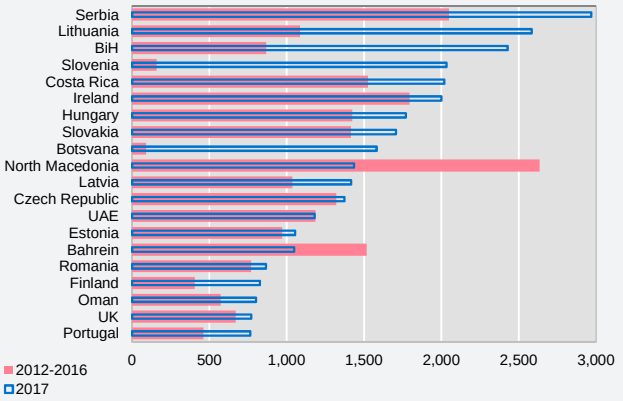


Source: NBS.

* Agriculture, industry, mining, transportation, catering.

The interest of foreign investors in long-term dinar government securities also intensified. Net inflow of non-residents' investments in government securities in the domestic market amounted to EUR 160.8 mn in 2018. As the financing needs were lower in Q4 2018, the government did not organise sale auctions, but an auction of early buyback of securities worth RSD 20 bn. In recent months, in an environment of Serbia's favourable macroeconomic prospects, but also better investor sentiment owing to announcements of a slower than previously expected normalisation of monetary policies of leading central banks, the demand in auctions of seven-year dinar securities exceeded the planned amount of sales (by four times in June and almost two times in July) resulting in more favourable borrowing conditions for the government. Net inflow from non-residents' investments in government securities in the domestic market in H1 2019 amounted to EUR 208.6 mn.

Chart O.1.4 **Top-ranking FDI destination countries by estimated jobs per million inhabitants**



Source: The Chart was taken over from IBM Global Location Trends 2018 and technically adapted for the *Inflation Report - August 2019*.

Note: It does not cover countries with population of less than one milllion.

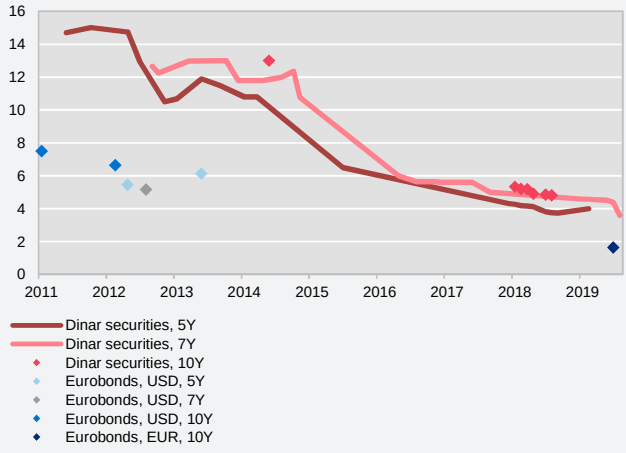
The readiness of foreign investors to commit to Serbia over a longer horizon is testified by the success of the ten-year eurobonds issued in the international financial market this June. Bonds were issued in euros, in the amount of EUR 1.0 bn, at the 1.5% coupon rate and the demand was 6.4 times higher than the supply. This lowered the borrowing costs relative to what was initially planned – the achieved yield rate (1.619%) is the lowest interest rate that Serbia has ever had in the international market. This rate is among the lowest rates on ten-year eurobonds in euros that governments in the region issued, even those countries whose credit rating is higher than Serbia's. The funds raised by this issue were used exclusively for early repayment of a part of bonds issued in dollars in 2013 and 2011, at significantly

higher coupon rates (4.875% and 7.25%, respectively), due in February 2020 and September 2021. This helped reduce interest expenses, as well as the currency risk on account of a lower share of public debt in dollars (cut to 22.0% in June).

Serbia's lower risk premium and a more favourable credit rating also contribute to more favourable borrowing conditions for the private sector. Measured by EMBI, on 24 July Serbia's risk premium plunged to 59 bp, touching its new historical low. From end-2012 Serbia's risk premium was lowered by over 300 bp, while EMBI Global Composite and EMBI Europe rose by around 80 bp in the same period, which indicates that the main drivers of Serbia's risk premium in the past years were the domestic factors. That the domestic economy is growing on healthy grounds has also been confirmed by rating agencies (Standard & Poor's, Fitch and Moody's) which upgraded Serbia's credit rating in 2017. In 2018 Standard & Poor's improved Serbia's credit rating outlook from stable to positive, which, in their estimate, is a reflection of expected robust economic growth, responsible fiscal policy and the government's commitment to reforms. In its press release from June this year, Standard & Poor's stated it could raise Serbia's rating (BB) in the next six to twelve months if strong economic growth continues, while public debt keeps declining and external imbalances remain contained.

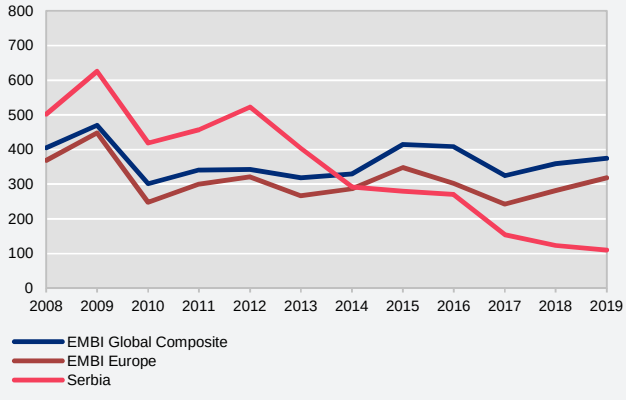
All of the above confirms that long-term investments of non-residents were profitable and in line with their expectations. At the same time, Serbia is strengthening its economic relations with the world, boosting employment and raising the standard of living on sustainable grounds. This, as well as the commitment of economic policy creators to maintain the results achieved and further improve the investment environment, reinforces the confidence and buttresses the prospects of our economy.

Chart O.1.5 **Interest rates in the primary market of dinar government securities and eurobonds**
(p.a., in %)



Source: Ministry of Finance.

Chart O.1.6 **EMBI Comosite and Serbia**
(annual average, in bp)



Source: JP Morgan.

Trends in the FX market and exchange rate

Appreciation pressures prevailing in the past period gained ground since June, as FX supply in the domestic FX market by far outstripped demand. The tailwinds came from the high FDI inflow and expansion in the goods and service exports, as well as from elevated non-resident interest and investment in long-term dinar government securities. Larger purchases of foreign cash, partly stemming from seasonally higher remittances inflows and non-resident card payments in Serbia also worked toward strengthening of the dinar. The rise in FX-indexed corporate lending, i.e. increase in FX-indexed bank assets[6], worked in the same direction.

To ease excessive short-term volatility of the dinar exchange rate against the euro, in the period April–July the NBS intervened in the IFEM purchasing EUR 1,565.0 mn. The EUR 735.0 mn FX purchase in June was the highest monthly purchase in this period.

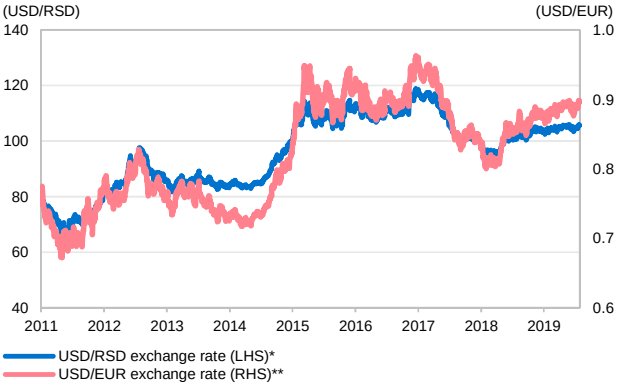
In such conditions, the dinar's value against the euro increased by 0.2% at end-July relative to end-Q1. At the same time, as the euro weakened against the US currency end-of-period, the dinar lost 0.5% relative to the dollar.

Daily trading volumes in the IFEM[7] averaged EUR 22.7 mn in Q2, contracting slightly (by EUR 0.7 mn) from Q1. The highest turnover was recorded in June (daily average of EUR 24.8 mn).

The trading volume at regular FX swap auctions organised by the NBS in Q2 was smaller than in Q1. At two-week auctions with banks, the NBS bought and sold EUR 94.0 mn each (EUR 124.5 mn less than in Q1), while at three-month auctions it bought and sold EUR 18.0 mn (EUR 4.0 mn more than in Q1). In addition, in Q2 the NBS organised three additional two-week FX purchase swap auctions, one in each month, at the start of the new required reserve maintenance period for banks. The auctions were organised in order to maintain the relative stability of short-term market interest rates in that period. In this way, banks were supplied with additional liquidity in Q2, in total amount of RSD 18.2 bn.

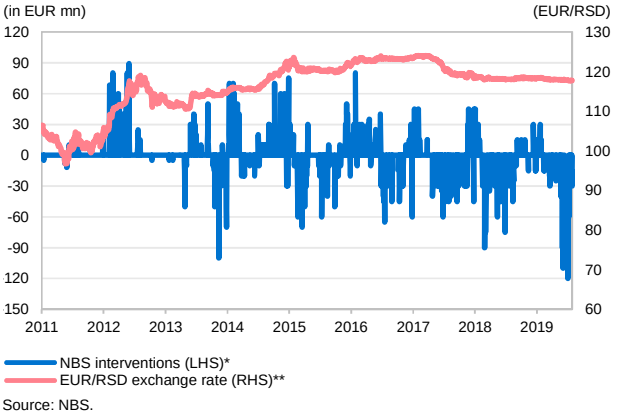
Other currencies of countries in the region running similar exchange rate regimes displayed divergent

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



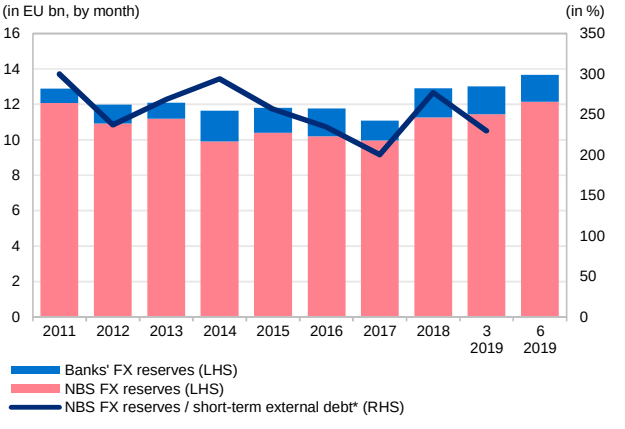
Source: NBS.
* USD 1 in RSD.
** USD 1 in EUR.

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



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

Chart IV.1.15 **FX reserves and coverage of short-term external debt**

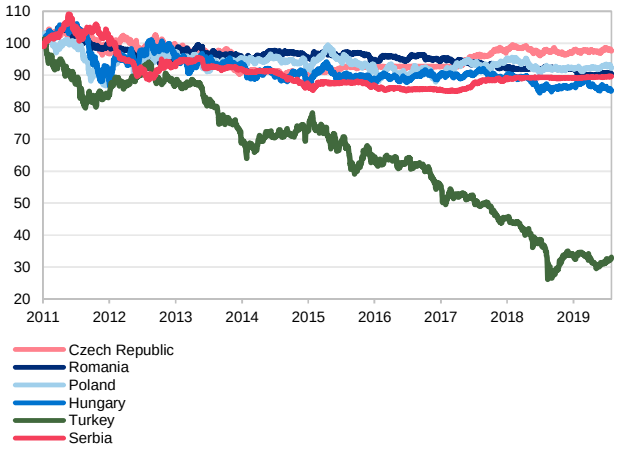


Source: NBS.
* Short-term debt by remaining maturity.

[6] Aiming to balance their open long FX position and thus reduce the exposure to FX risk, banks sell foreign currency, which leads to strengthening of the dinar.

[7] Excluding the NBS.

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



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

movements in Q2. The currencies which gained ground end-of-period were the Czech koruna (1.4%), Polish zloty (1.2%) and Romanian leu (0.6%), while the Hungarian forint weakened by 0.8%, and Turkish lira by 4.9%.

2 Money and loans

Monetary aggregates continued up on the back of credit activity which increased 9.4% y-o-y in June, excluding the exchange rate effect. The rise in government deposits with the NBS aided by the positive fiscal result in H1 of the current year, worked in the opposite direction.

Monetary aggregates

In Q2, monetary aggregate M3 gained 0.8%, owing to the rise in the dinar component. The greatest contribution came from transaction deposits[8], which increased by RSD 29.8 bn in Q2. Corporate transaction deposits were RSD 16.5 bn stronger, and increases were recorded in company accounts across almost all sectors. In Q2, households increased transaction deposits by RSD 14.6 bn, while account balances of other sectors remained almost unchanged relative to Q1.

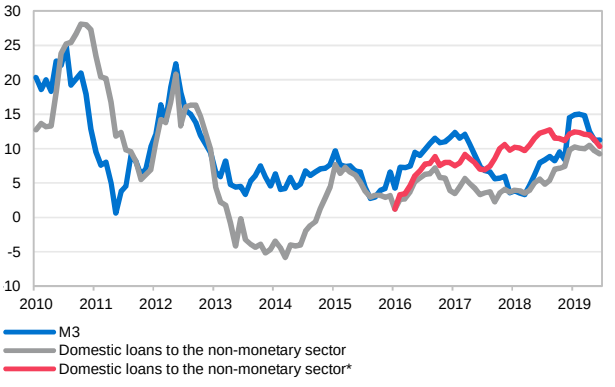
Table IV.2.1 **Monetary aggregates**
(nominal y-o-y rates, in %)

	2018		2019		Share in M3 June 2019 (in %)
	Sep.	Dec.	March	June	
M3	8.2	14.5	14.8	11.2	100.0
FX deposits	5.2	13.2	13.9	8.6	60.5
M2	13.5	16.7	16.2	15.4	39.5
Time and savings dinar deposits	8.7	11.4	15.9	15.2	9.9
M1	15.1	18.3	16.4	15.5	29.6
Demand deposits	14.6	20.6	16.1	15.1	22.5
Currency in circulation	16.5	11.4	17.3	17.0	7.1

Source: NBS.

Dinar time deposits of non-monetary sectors increased by RSD 19.1 bn in Q2. All sectors increased their dinar time deposits, testifying to the growing confidence in the domestic currency.[9] Dynamic growth of dinar household savings recorded in 2018 (22.2%) extended into 2019. Dinar household savings gained RSD 4.0 bn in Q2 (RSD 8.2 bn since the start of the year), arriving at RSD 68.6 bn in June. They continued up in July, and according to the preliminary data, reached the new maximum of over RSD 70 bn. The growth in dinar savings is also encouraged by their greater profitability compared to the FX savings – higher interest rates on dinar (around 3.0%) than on FX savings (around 1.0%), more favourable tax treatment and the preserved price stability and relative stability of the exchange rate. The Analysis of profitability of dinar and foreign currency savings[10], regularly published by the NBS (the latest one covering the period from June 2013 until June 2019), also speaks in favour of greater profitability of saving in the domestic currency, both in

Chart IV.2.1 **Domestic loans to the non-monetary sector and M3**
(nominal y-o-y rates, in %)



Source: NBS.
* Excluding the effect of NPL write-off and sale since early 2016.

[8] After a seasonal decrease in Q1.

[9] Deposits of other financial organisations increased by RSD 7.9 bn, of local authorities by RSD 4.3 bn, and of corporates by RSD 2.3 bn.

[10] For a more detailed account, see the Analysis published on the NBS website on 22 July 2019. (http://www.nbs.rs/internet/english/15/mediji/vesti/isplativost_stednje_2019.pdf).

the long- and short-term. The share of dinar in total deposits increased compared to end-2018, both in the corporate and household sectors – 55.0% and 20.0% respectively at end-Q2.

In Q2, FX deposits declined by EUR 296.1 mn, as corporate accounts recorded a decrease of EUR 476.9 mn, due to the April payouts to the government and disbursement of dividends under the concession of Nikola Tesla airport. On the other hand, FX savings of households continued up. Gaining EUR 161.7 mn in Q2 and EUR 418.0 mn since the start of the year, household FX savings reached their new maximum of EUR 10.1 bn in June.[11]

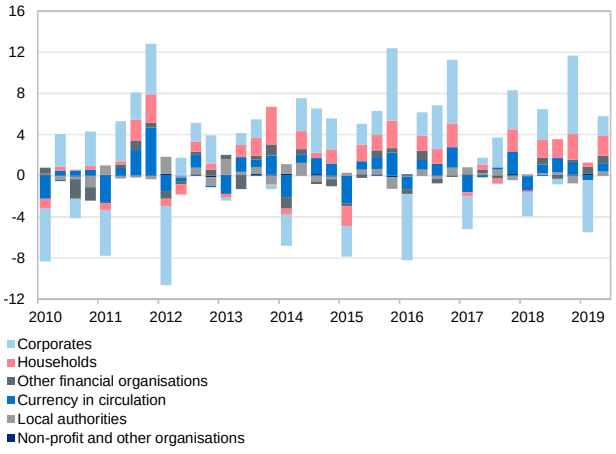
In y-o-y terms, M1, M2 and M3 increased by 15.5%, 15.4% and 11.2% respectively in June. An impetus to total money growth (M3) came from credit activity, while the increase in government deposits with the NBS thanks to the H1 2019 fiscal surplus worked in the opposite direction.

Loans

Excluding the exchange rate effect, total domestic loans recorded y-o-y growth[12] of 9.4% in June (10.1% at end-Q1) – with corporate loans picking up to 8.9% (from 7.8% in March) and household loans slowing to 9.7% (from 12.3% in March). Banks continued their NPL resolution efforts in 2019. Since the start of the year, they have written off RSD 7.0 bn worth of NPLs (RSD 3.0 bn of which in Q2) and sold another RSD 3.1 bn of these loans to non-banking sector entities directly from their balance sheets (RSD 1.7 bn of which in Q2). Excluding the effect of NPL write-off and sale[13], y-o-y growth of domestic loans reached 10.5% in June 2019, with household loans rising by 10.2% and corporate loans by 10.6%, y-o-y.

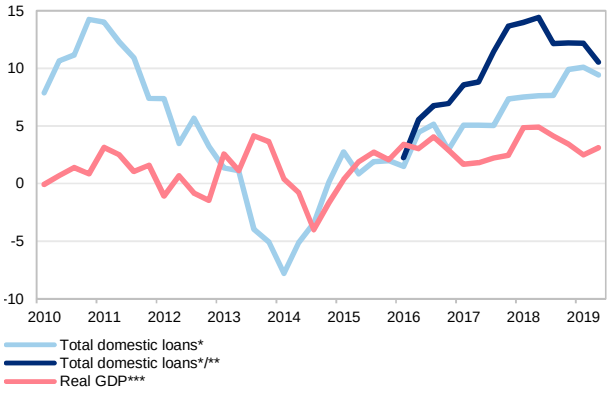
In the year to date,[14] excluding the exchange rate effect, corporate loans gained RSD 26.3 bn, driven by the growth of company loans. In terms of purpose, the increased disbursement of investment loans (RSD 39.0 bn increase

Chart IV.2.2 **Contributions to quarterly growth in M2, by sector**
(in pp)



Source: NBS.

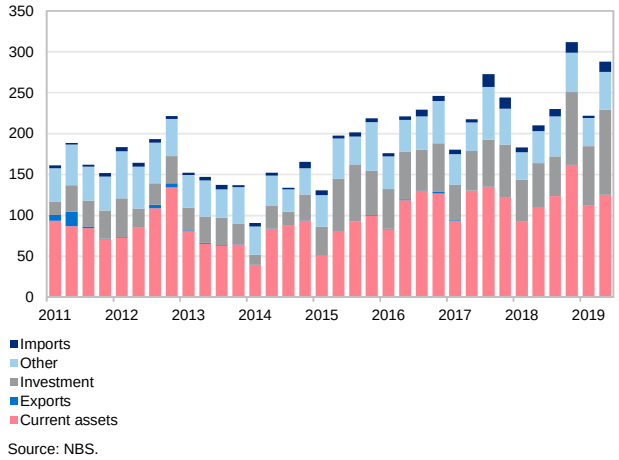
Chart IV.2.3 **Lending activity and GDP**
(y-o-y rates, in %)



Sources: NBS and SORS.

* Excluding the exchange rate effect.
** Excluding the effect of NPL write-off and sale since early 2016.
*** NBS estimate for Q2 2019.

Chart IV.2.4 **Structure of new corporate loans, by purpose**
(in RSD bn)



Source: NBS.

[11] Money supply M3 includes only resident funds. With non-resident funds included, at end-June dinar savings equalled RSD 69.3 bn and FX savings EUR 10.4 bn.

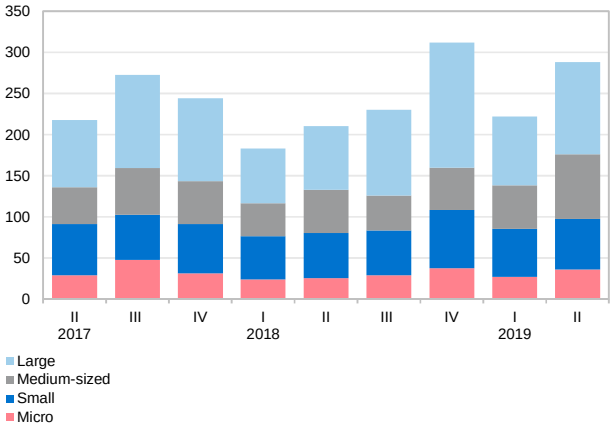
[12] Calculated at the dinar exchange rate against the euro, Swiss franc and US dollar as at 30 September 2014 (the so-called programme exchange rate), taking into account the currency structure of loan receivables.

[13] Excluding the NPL write-off and sale effect since the beginning of 2016. Concluding with June 2019, banks wrote off RSD 189.3 bn worth of NPLs (of which RSD 140.4 bn of corporate loans, and RSD 44.0 bn of household loans), and sold RSD 91.9 bn worth of NPLs, which were at their balance sheets at the moment.

[14] After the seasonally lower disbursement in Q1, when loans to corporates increased by RSD 1.0 bn.

since the start of the year) made these loans, as of May, the dominant category of corporate loans, accounting for 41.9% in June. Next in size were loans intended for current assets financing, accounting for 41.2%, and non-categorized loans – 11.3% of total corporate loans. Sector-wise, companies in construction, real estate, transport and trade recorded the strongest lending growth. Loans to companies in agriculture, electricity supply and manufacturing were on a mild decline, while loans to other sectors kept the same levels as at end-2018.

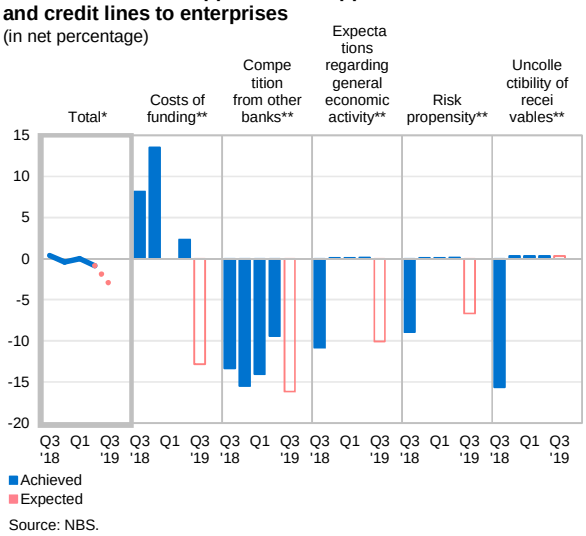
Chart IV.2.5 **Structure of new corporate loans, by enterprise size**
(in RSD bn)



Source: NBS.

In Q2, **the amount of new corporate loans** (RSD 287.9 bn) was up by 37.0% relative to the same period last year, or by 26.2% excluding the effect of loans refinanced with the same bank. Greatest disbursements concerned current assets loans (RSD 125.0 bn), which made up 43.4% of total corporate loans approved in Q2. Over 70% of these loans went to the corporate segment of micro-, small- and medium-enterprises. Thanks to the high disbursement of investment loans in Q2, their share in new corporate loans came at 36.2%, with the highest amounts approved to large enterprises. In Q2, the volume of new investment loans, excluding the loans refinanced with the same bank, increased by 89.6% from the same period last year – signalling the continuation of positive trends in corporate investment.

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.

The results of the **July NBS Bank Lending Survey**[15] show that corporate credit standards remained almost unchanged in Q2, for the fourth consecutive quarter. Banks deem that stronger market competition, lower cost of funding, positive expectations regarding the overall economic situation and greater risk appetite will contribute to the easing of corporate credit standards in Q3. In banks' judgement, corporate demand has expanded, driven by large enterprises, agricultural producers and small and medium enterprises. Banks expect this trend to extend into Q3, with capital investment and current assets financing remaining the main drivers of demand. The CESEE Bank Lending Survey published biannually by the EIB also points to positive trends in the corporate credit market.[16] The survey underscores healthy growth in loan demand (especially from small and medium enterprises), with improved quality of credit conditions and almost unchanged credit standards in H1.

[15] The NBS implements the survey since the start of 2014.

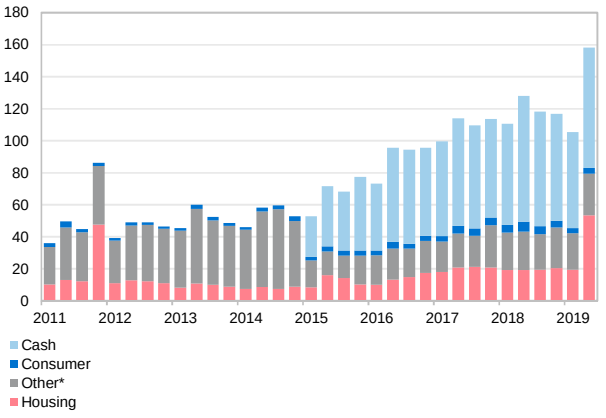
[16] Ten banks from Serbia, whose assets make up somewhat less than a half of total Serbian banking sector assets, participate in this survey (http://www.eib.org/infocentre/publications/all/cesee-bls-2017-h2.htm).

Since the start of the year and excluding the exchange rate effect, **household loans** grew by RSD 38.6 bn – driven by cash and housing loans which remained the two dominant categories in June, accounting for 41.8% and 36.5% of all bank household receivables, respectively. Since the beginning of 2019 cash loans increased by RSD 28.4 bn, or RSD 4.2 bn less than in the same period last year. Such movements indicate that NBS's measures aimed at curbing non-purpose lending to households at unreasonably long maturities adopted in December 2018 are yielding results. In the first six months of 2019 housing loans grew by RSD 1.0 bn, despite the fact that, in accordance with the Law on the Conversion of Housing Loans Indexed to Swiss Francs, 38% of the value of converted loans is written off at conversion (concluding with June, RSD 17.9 bn of these loans were written off).

The volume of new household loans in Q2 2019 (RSD 158.4 bn) increased by 23.8% y-o-y, or by 2.6% excluding the loans refinanced with the same bank. Cash loans, over 99% of which are in dinars, accounted for the greatest share (47.6%). Compared to the same period last year their disbursement declined by 4.2%, or 8.0% excluding the loans refinanced with the same bank – which confirms that NBS's measures from December 2018 slightly moderated the growth in cash loans. The volume of new housing loans (RSD 53.5 bn) increased by almost three times y-o-y, or by 37.6% excluding the loans refinanced with the same bank. The higher amount of new housing loans partly stemmed from the recovery of housing lending and real estate market rebound, but in greater part reflected the conversion of Swiss franc- to euro-indexed loans.

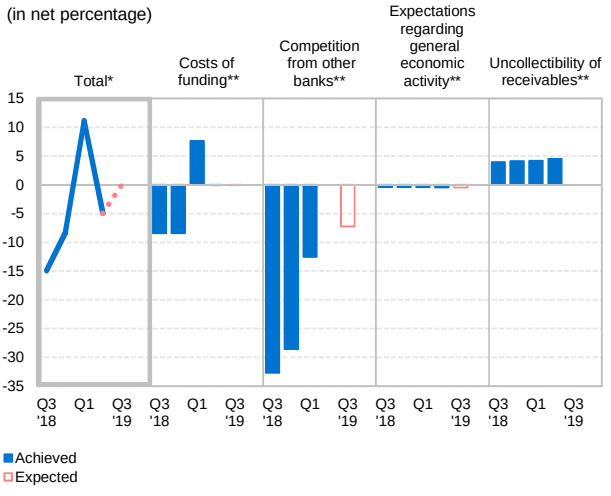
The results of the **July Lending Survey** show that, in banks' assessment, household lending standards eased slightly in Q2. Banks expect a mild further easing of standards in Q3, due to competition. In banks' view, household loan demand increased in Q2 on the back of real estate and durable consumer goods purchases, as well as due to refinancing needs. According to banks, such trends are likely to extend into Q3. The results of the EIB survey point to similar conclusions, underlining healthy growth in household loan demand. The survey particularly underscores higher housing loan demand of households, detecting also an improvement of credit conditions in this segment.

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



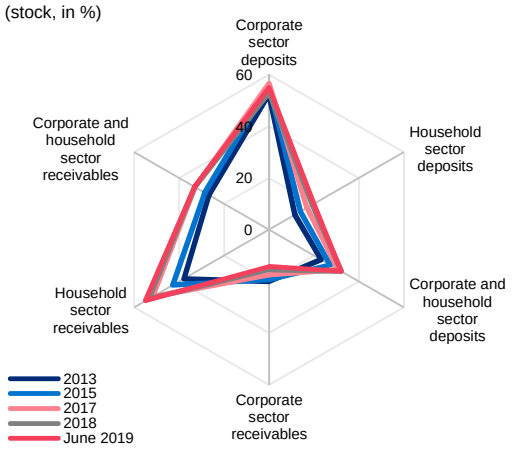
Source: NBS.
* Until December 2014, the 'Other loans' category included both cash and other loans.

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)



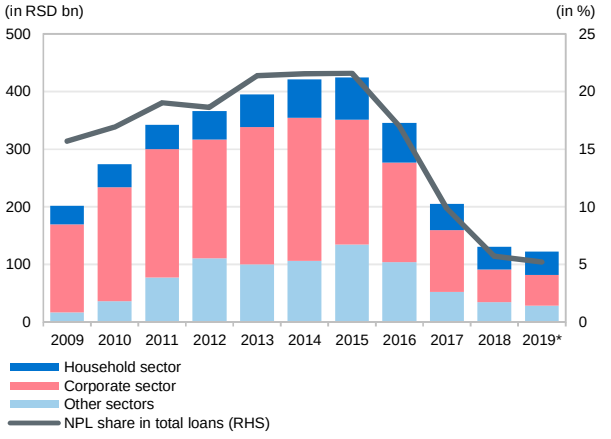
Source: NBS.
* Positive values indicate tightening and negative easing of credit standards relative to the previous quarter.
** Positive values indicate the contribution of individual factors to tightening, and negative values indicate the contribution to easing of credit standards.

Chart IV.2.9 **Dinarisation of corporate and household deposits and receivables**
(stock, in %)



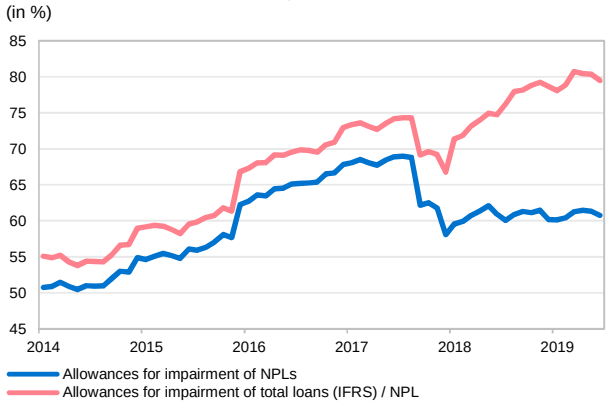
Source: NBS.

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



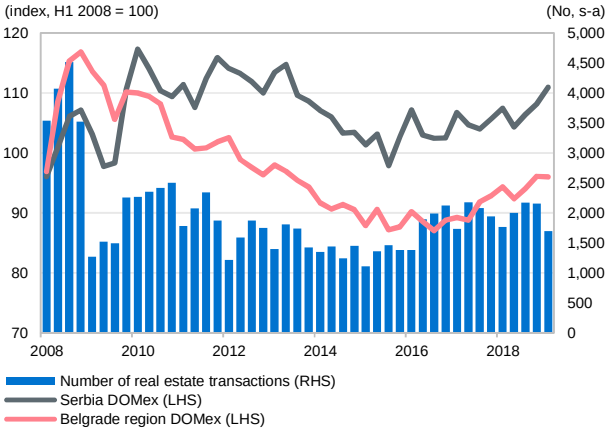
Source: NBS.
* June 2019.

Chart IV.2.11 **Selected banking sector indicators**



Source: NBS.

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



Source: National Mortgage Insurance Corporation.

At end-June, the share of dinar receivables in total corporate and household receivables stood at 33.2% (rising by 0.2 pp from end-2018). The dinarisation of household receivables reached maximum 55.0% in June, while the dinarisation of corporate receivables measured 14.3%.

Positive trends in the credit market are reflected also in excellent results of the NPL Resolution Strategy. In less than four years since the Strategy was adopted, the **stock of NPLs** in the banking system decreased by over 71% and their share in total loans by 17.2 pp. From the beginning of 2019, the NPL share in total loans dropped by 0.5 pp to a new minimum of 5.2% in June, of which the NPL share in the corporate sector shrunk by 0.4 pp to 4.6%[17], while flatlining at 4.4% in the household sector[18]. The NPL coverage remained high – allowances for impairment for total loans measured 79.5% of NPLs in June, while allowances for impairment for NPLs stood at 60.8% of NPLs. Also, after the introduction of Basel III standards,[19] the capital adequacy ratio rose further, to 23.2% at end-Q2 2019, indicating high capitalisation of the domestic banking sector.

3 Real estate market

Supply and demand indicators signal a recovery in the real estate market, which may be expected in the coming period as well.

Judging by the supply and demand indicators, the real estate market continued to recover in Q2. The number of construction permits issued in residential construction went up by 11.1% y-o-y in April and May. Positive trends in the housing credit market also continued, as evidenced by the volume of newly approved housing loans. In the Bank Lending Survey banks reported elevated household demand for housing loans in Q2 and the expectation for this growth to extend into Q3.

According to the latest available data for Q1, the average price of real estate in Serbia, as measured by DOMex[20], increased 2.6% since the start of the year and 3.3% relative to the same period of 2018. Real estate prices rose in the regions of Vojvodina (8.9% y-o-y), Šumadija and

[17] Includes companies and public enterprises. Looking only at companies, the share of NPLs in total loans came at 4.7% in June, down by 0.5 pp from December 2018.

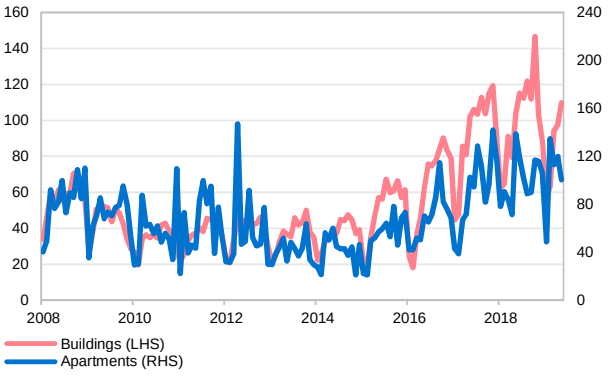
[18] If entrepreneurs and private households are included the share is also at the same level where it stood at the end of the last year – 4.4%.

[19] The regulatory Basel III framework is applied as of 30 June 2017.

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

Western Serbia (4.9% y-o-y), and to a lesser degree also in the Belgrade region (1.7% y-o-y), while declining in Southern and Eastern Serbia by 1.8% y-o-y. In Q1, the average real estate price in Serbia equalled EUR 934.0 per square metre. Real estate remained the most expensive in the Belgrade region, with the average price of EUR 1,217.9. The ratio of average prices in Belgrade and other regions equalled 1.77. In Q1, the number of real estate transactions[21] contracted by 3.9% y-o-y.

Chart IV.3.2 **Indices of the number of issued construction permits for new construction**
(quarterly averages s-a, 2018 = 100)



Sources: SORS and NBS calculation.

4 Aggregate demand

Faster GDP growth in Q2 (3.1% y-o-y) relative to Q1 (2.5% y-o-y) reflects stronger pace of investment, as confirmed by intensive implementation of infrastructure projects and a higher FDI inflow. The rise in household consumption, on the back of continued positive trends in the labour market, provided a similar contribution as in Q1. On the other hand, since imports grew faster than exports, net exports were a negative contributor.

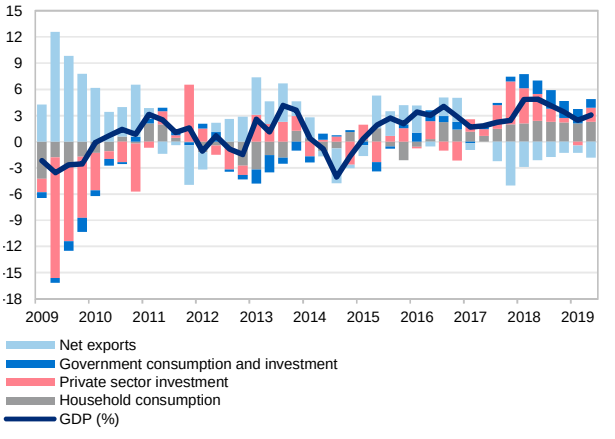
Domestic demand

In NBS's estimate, a steady rise in **household consumption** extended into Q2, reaching 3.3% y-o-y and adding 2.3 pp to GDP growth. Service sector indicators, posting an increase in Q2, bear out our estimates. Retail trade turnover increased by 7.8% y-o-y in real terms, and the number of domestic tourist arrivals and overnight stays went up by 7.1% and 7.6%, respectively. Also, imports of consumer goods was up by 17.3% y-o-y.

In the first two months of Q2, the wage bill, which is the main source of household consumption, gained 12.0% y-o-y in real terms, reflecting employment and wage increases. This offset the contraction in alternative sources of household consumption – remittances and consumer loans. Remittances shrunk by 5.3% y-o-y in Q2, while the volume of new consumer and cash loans to households contracted by 6.9% y-o-y, chiefly due to the NBS's measures aimed at safeguarding financial stability.

Government consumption is also estimated to have edged up by 2.5% y-o-y in Q2, adding 0.4 pp to GDP growth. The rise in government consumption is indicated by the real growth of public sector employee expenditures, by 7.3% y-o-y in Q2, as well as of

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



Sources: SORS and NBS calculation.
Note: NBS estimate for Q2 2019.

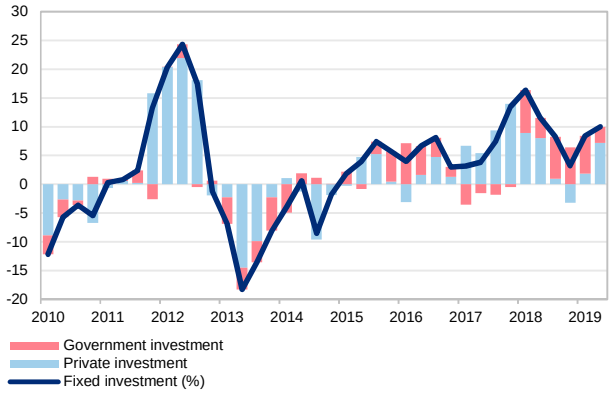
Table IV.4.1 **Movement in main indicators and sources of household consumption**
(real y-o-y growth rates, in %)

	2018		2019	
	Q3	Q4	Q1	Q2
Household consumption	**3.3**	**3.2**	**3.2**	**3.3 ***
Indicators				
Retail trade	4.8	4.8	8.6	7.8
Catering turnover	11.0	9.1	10.1	7.2 **
Number of domestic tourists	8.6	5.8	3.5	7.1
Number of overnight stays of domestic tourists	10.2	6.7	1.3	7.6
Consumer goods imports (BEC classification), nominal	10.6	16.4	11.0	17.3
Sources				
Total wage bill, nominal	9.9	11.3	14.3	14.8 ***
Net remittances inflow, nominal	35.5	6.4	2.6	-5.3
New consumer and cash loans, nominal	10.8	7.0	-6.8	-6.9

Sources: SORS and NBS calculation.
* NBS estimate.
** April (SORS estimate).
*** April–May.

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

Chart IV.4.2 **Fixed investment**
(y-o-y growth, in pp)



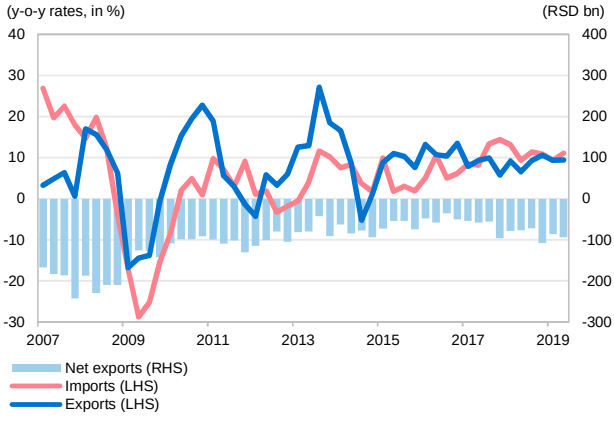
Sources: SORS and NBS calculation.
* NBS estimate for Q2 2019.

Table IV.4.2 **Investment indicators**

	2018			2019	
	Q2	Q3	Q4	Q1	Q2
Real y-o-y growth rates (in %)					
Fixed investment (national accounts)*	11.6	8.3	3.2	8.4	10.0
Construction (national accounts)*	20.4	9.9	2.7	12.3	22.0
Government investment*	28.9	51.9	41.9	32.9	20.0
Number of construction permits issued	6.9	6.3	-1.8	0.0	11.1 **
Production of construction material	7.2	11.0	5.5	10.6	-0.6
Value of works performed	24.9	7.0	3.0	13.6	18.9
Imports of equipment, nominal	13.2	15.8	8.5	18.2	7.0
Production of domestic machinery and equipment	12.6	3.4	8.7	16.1	-5.6
Finished product inventories in industry	9.8	13.6	9.9	3.9	0.7

Sources: SORS and NBS calculation.
* NBS estimate for Q2 2019.
** April–May.

Chart IV.4.3 **Exports and imports of goods and services**
(in previous-year constant prices, ref. 2010)



Sources: SORS and NBS calculation.
Note: NBS estimate for Q2 2019.

expenditures for the purchase of goods and services, by 4.7% y-o-y in the same period.

In quarterly terms, household and government consumption continued up at a similar pace as in Q1 (0.8% s-a and 0.6% s-a, respectively) and, taken together, added 0.7 pp to GDP growth.

A favourable medium-term growth outlook boosted **private investment**, which is estimated to have increased 8.4% y-o-y in Q2 (1.5 pp contribution to GDP growth). This is confirmed by positive movements of indicators of investment in equipment, as equipment imports expanded by 7.0% y-o-y in Q2, while the production of capital goods increased by 0.8% y-o-y. The investment upswing in Q2 is signalled also by favourable movements of construction indicators – increase in the value of works performed (18.9% y-o-y), employment figure (9.0% y-o-y) and the number of construction permits issued (11.1% y-o-y in the period April–May). Accelerated implementation of government-financed infrastructure projects in Q2 signals further growth in **government investment** (over 20% y-o-y), so the contribution of total investment to GDP growth in Q2 is estimated at 2.0 pp. In quarterly terms, fixed investment rose by 5.0% s-a in Q2, adding 1.0 pp to GDP growth.

Looking at sources of investment financing, positive trends continued, aided by a further improvement of the investment environment and favourable borrowing terms in the domestic and international financial markets. Thus, the net FDI inflow reached almost EUR 1 bn in Q2, rising by 45% y-o-y. In the same quarter, banks approved a record amount of corporate investment loans – RSD 80.4 bn, excluding the loans refinanced with the same bank, which is 89.6% more than in Q2 2018.

Growing exports of agricultural products in Q2 depleted total inventories which are estimated to have provided a negative contribution to quarterly GDP (0.2 pp).

Net external demand

The external trade volume expanded in Q2, with both exports and imports picking up. Still, imports grew faster (11.1% y-o-y in real terms) than exports (9.4% y-o-y in real terms), so net exports' contribution to GDP remained negative, coming at 1.8 pp in Q2.

According to balance of payments data, euro-denominated commodity exports sped up to 8.8% y-o-y in Q2, despite the slowdown in external demand. External trade data suggest that the main contributor was

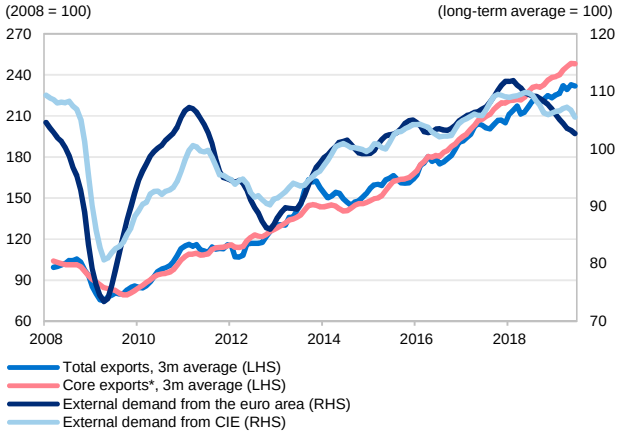
manufacturing, whose exports accelerated by 6.0% y-o-y in Q2. Manufacturing exports growth was widely dispersed – across 17 out of 23 branches, most notably in electrical equipment (26.9% y-o-y) and machinery and equipment (17.6% y-o-y). High contributions also came from exports of rubber and plastic products (10.5% y-o-y) and exports of base metals (9.0% y-o-y), primarily copper. Set against that, overhauls in the oil refinery in Pančevo and Petrohemija dampened the exports of petroleum and chemical products. Negative contributions also came from motor vehicle exports (-3.7% y-o-y), though exports of automobile parts and equipment picked up, reaching 14.8% of the total commodity exports in H1 and largely compensating for the lower automobile exports. Thanks to the well-performing season last year, exports of agricultural products continued up in Q2 (18.1% y-o-y). The main impetus came from exports of cereals (EUR 191.5 mn), up by EUR 44.7 mn compared to the same period last year.

Balance of payments data indicate that exports of services continued their high growth (16.0% y-o-y in Q2), led mainly by the buoyant exports of business (28.1% y-o-y) and information and communication services (32.5% y-o-y). At the same time, exports of transport, tourist and other services also went up.

In Q2, euro-denominated commodity imports rose by 10.1% y-o-y, driven mainly by imports of intermediate goods (up by EUR 237.0 mn) meeting the elevated needs in manufacturing and construction. Higher imports of energy (up by EUR 43.4 mn), mostly of petroleum products, also contributed to growth, as the domestic market, faced with the Pančevo refinery overhaul, imported the needed quantity of such products. Consistent with the ongoing investment cycle, equipment imports went up by EUR 48.3 mn, while higher imports of consumer goods (by EUR 170.4 mn) indicates a further recovery in household consumption. Similar trends are confirmed by the imports structure according to the EU classification into end-use categories, which shows that the greatest contributions to imports came from intermediate goods and non-durable consumer goods, followed by energy and, to a lesser extent, also from capital goods.

In June 2019, the commodity exports-to-imports ratio measured 73.9%, or 83.2% if services are included, similar as at end-2018. In June, exports of goods were 135.0%[22], and imports of goods 39.4% above their pre-crisis levels.

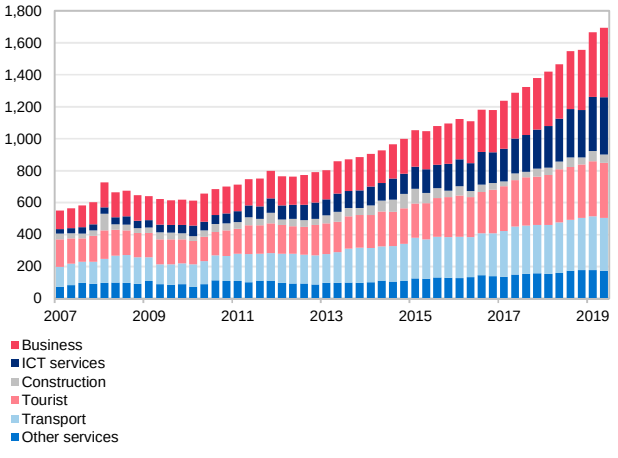
Chart IV.4.4 **Movement of indicators of external demand for Serbian exports**
(3m moving avarage, s-a)



Sources: European Commission, SORS and NBS.

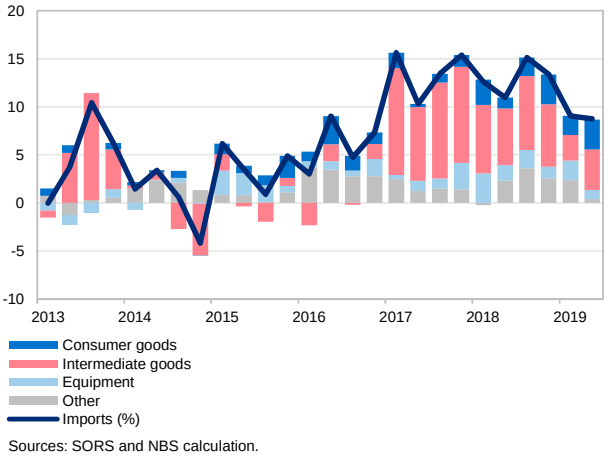
* Core exports are total exports excluding exports of agricultural products, base metals, motor vehicles, petroleum products and electricity.

Chart IV.4.5 **Exports of services**
(s-a quarterly data, in EUR mn)



Sources: SORS and NBS calculation.

Chart IV.4.6 **Movement of key import components**
(contributions to y-o-y growth, in pp)



Sources: SORS and NBS calculation.

[22] Level from H1 2008.

Text box 2: Serbia's position in the global services market

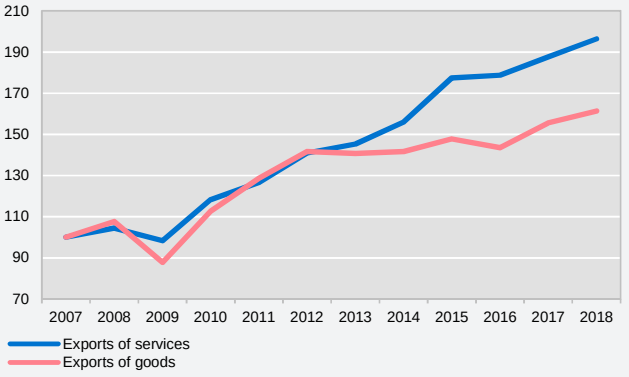
Success in the emerging global services market has become one of the key factors of economic growth and employment, particularly in small and open economies such as Serbia. While a few decades ago they were intended primarily for the domestic market, with technological progress and structural changes of the global economy, services have become increasingly tradeable and are today exported to the global market in conditions of high competition. The rising importance of services is additionally spurred by the development of digital technology and global value chains.

Trade in services in the global market has recorded more robust growth than trade in goods. The global exports of services reached almost EUR 5 tn last year, which is twice higher than in 2007, led primarily by the vigorous rise in demand from Asian countries. At the same time, the value of global exports of goods increased significantly, albeit to a lesser extent (60%), so the share of services in total global exports rose from 20.1% to 22.5%. Such trend is expected to continue in the coming period.

Growth in services exports was even more vibrant than at the global level. Last year, the value of services that Serbia exported to the global market was close to EUR 6 bn, up by 160% from 2007. In the period observed, the value of services exports was rising each year, except for 2009, when a decline was noted at the global level as well due to the global economic crisis. At the same time, over the past years Serbia has been recording particularly high growth rates of services exports, on the back of macroeconomic stabilisation, improved terms of doing business and growth of export-oriented service enterprises. The robust growth in services exports enabled Serbia to make a shift from a trade in services deficit of EUR 245 mn in 2007 to a surplus of EUR 1.1 bn in 2018, thus contributing significantly to a reduction in the current account deficit.

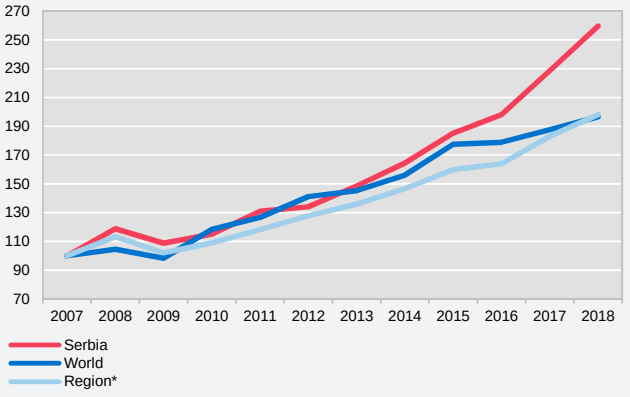
A small number of countries at the global level recorded faster growth in services exports than Serbia. Compared to countries of the region, Serbia recorded the fastest growth in services exports in the period observed. In addition to Serbia, over the past several years, Poland and Romania also recorded a vibrant rise in services exports, and the common feature of all three countries is that they are

Chart O.2.1 **Global exports of goods and services**
(index, 2007 = 100)



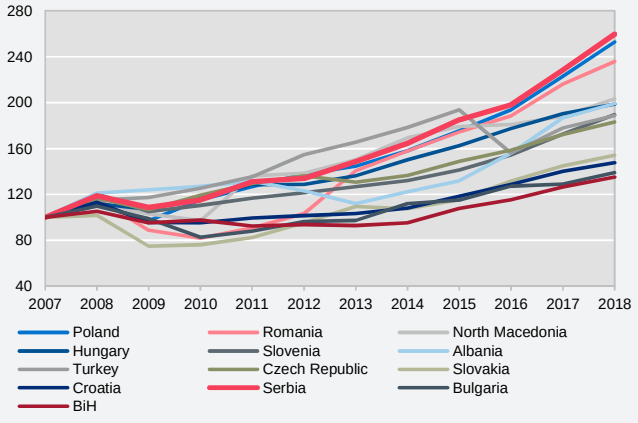
Source: International Trade Centre.

Chart O.2.2 **Services exports of Serbia, the region and the world**
(index, 2007 = 100)



Source: International Trade Centre.
* Albania, Bosnia and Herzegovina, Bulgaria, Czech Republic, Croatia, Hungary, Poland, Romania, North Macedonia, Slovakia, Slovenia and Turkey.

Chart O.2.3 **Services exports of Serbia and countries in the region**
(index, 2007 = 100)

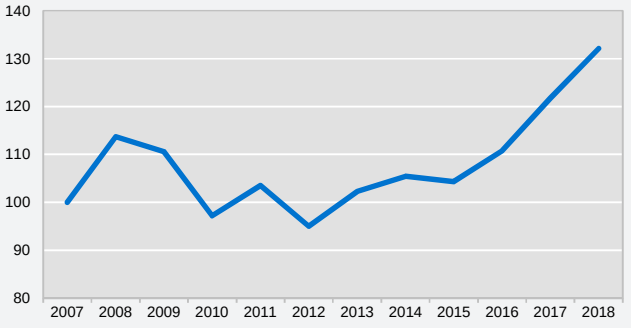


Source: International Trade Centre.

increasing the exports of ICT[1] services at the fastest pace in the global market.

With vibrant growth in services exports, Serbia increased its share in the global market by 40% in 2018 compared to 2007. Serbia has been recording a vigorous rise in its exports share in the global market over the past years, which suggests enhanced competitiveness of Serbia's services sector. These results are even more important given that they were achieved against the background of tougher competition in the international market and geopolitical and trade tensions.

Chart O.2.4 **Share of Serbia's services exports in the global market**
(index, 2007 = 100)

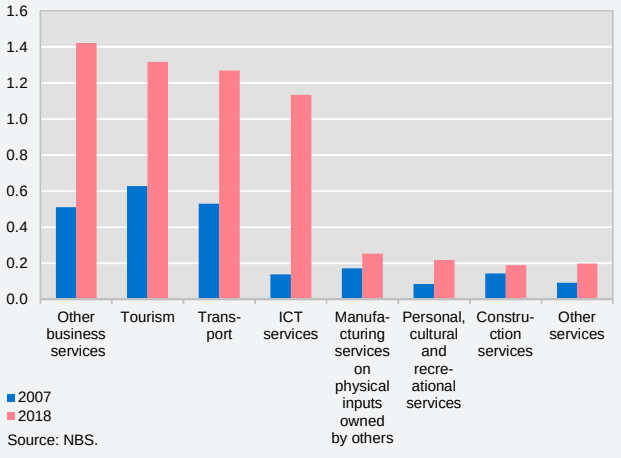


Source: International Trade Centre.

The strengthening of export orientation in the services sector confirms the increase in the share of services exports in Serbia's GDP, from 7.3% in 2007 to 14.0% in 2018. For the sake of comparison, in EU-28, the share of services exports in GDP rose from 9.7% to 13.5% in the same period.

Observed by the category of services, Serbia increased the most its ICT services exports, i.e. by over eight times in the 2007–2018 period. In this way, Serbia turned the deficit in trade in ICT services worth EUR 35 mn in 2007 into a surplus worth EUR 615 mn in 2018. Within ICT services, the exports of computer services rose at the fastest pace, at the average annual rate of 30%, from EUR 61 mn in 2007 to over EUR 1 bn in 2018, reaching 90% of the value of ICT services exports. Particularly important is the fact that the fastest growth was recorded in the category of services entailing technological innovations and know-how. In addition, in the period observed, the growth in computer services exports was stable – even in the years when trade in these services contracted at the global level (2013 and 2018), Serbia was recording growth of 34%. In terms of the absolute value of the exports of these services, among the countries in the region, Serbia reached Slovakia, which is behind Poland (EUR 5.7 bn), Romania (EUR 3.3 bn), the Czech Republic (EUR 2.8 bn) and Hungary (EUR 2 bn). All other countries of the region are exporting computer services to a lesser extent. In terms of geographic destination, Serbia exported most computer services to the largest world markets in this area, such as the USA, Germany and the Netherlands.

Chart O.2.5 **Serbia's services exports by category**
(in EUR bn)



Source: NBS.

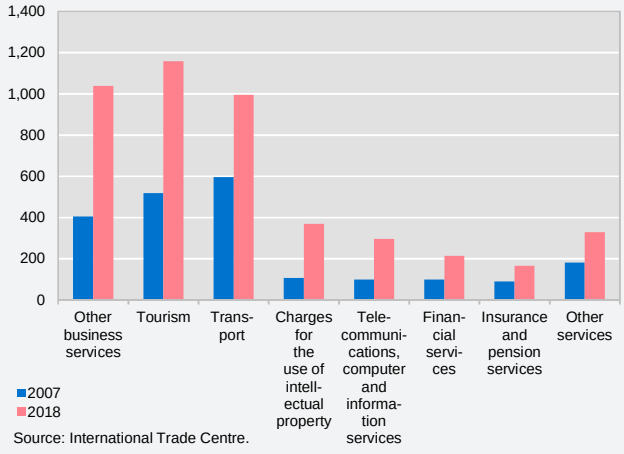
The following category of services which recorded significant growth in Serbia's exports are other business services, which reached EUR 1.4 bn in 2018, increasing by 179% from 2007. The most important among them are professional and managerial counselling services, whose exports were worth EUR 787 mn, and trade-related technical services, whose exports were worth EUR 538 mn in 2018. Based on other business services, the surplus in trade with the rest of the world went up, from EUR 44 mn in 2007 to EUR 447 mn in 2018.

In terms of the structure of services, particularly important are transport and tourism, whose exports increased by 140% and 109% respectively in 2007–2018. A moderate surplus was recorded for transport, and a deficit for tourism. Tourism is the area where Serbia can use its potentials to a larger extent and step up its FX inflows, given that the global growth in

[1] Telecommunications, computer and information services.

trade in tourist services reached EUR 1.2 tr last year, up by 124% compared to 2007. The overview of changes in the value of global imports by the category of services in the period observed is presented in Chart O.2.6.

Chart O.2.6 **Global imports by service category**
(in EUR bn)



Source: International Trade Centre.

Changes in the period observed also took place in the most important markets for services exports. The USA remains the world's largest importer of services, with China recording the strongest growth. It almost quadrupled its services imports in 2007–2018 (while the value of services exports is twice higher). In the structure of services imports of China, tourism is by far the most important, its share going up from 23% to 53% in the review period. Among the most important markets at the global level are India and Singapore, which pushed back Italy and Spain from the list of the world's ten largest importers of services.

Although global trade has been showing signs of weaknesses since the start of this year due to trade and geopolitical tensions, Serbia's services exports continued up at a brisk pace. In the first six months of the year, services exports rose by 16.7% y-o-y. The largest growth was recorded for the exports of computer services (30.9% y-o-y) and other business services (23.3% y-o-y). In the period to come, we expect a further rise in Serbia's exports and their share in the global market, bearing in mind primarily the potential of the IT sector. Serbia's positive results in the global services market, which features state-of-the-art technologies, knowledge and innovations, will result in further narrowing of external imbalances, rising employment, primarily of highly educated staff, higher productivity and sustainable economic growth.

5 Economic activity

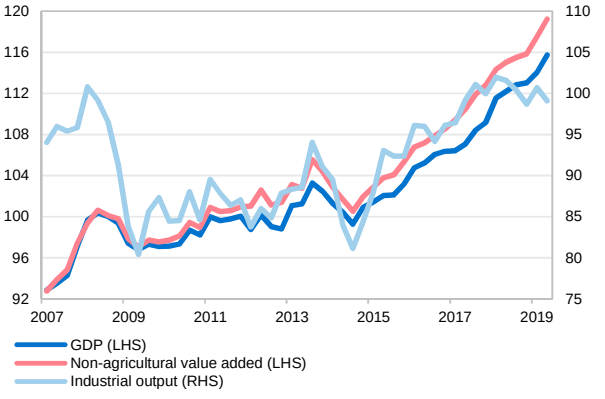
Stepped-up activity in construction and continued rise in services accelerated GDP growth in Q2 to 3.1% y-o-y in our estimate (1.5% s-a). The recovery of industrial production is expected by the end of the year which, coupled with the further rise in the sectors of construction and services, will result in 3.5% economic growth in 2019.

GDP growth extended into the 19th consecutive quarter - our estimate is that it accelerated to 1.5% s-a in Q2. A sharper increase relative to Q1 is a reflection of positive developments in construction (8.0% s-a) and services (1.4% s-a). On the other hand, the contribution of agriculture and industry to economic growth in Q2 is estimated to have been almost neutral. Industrial production did not record the expected quarterly growth due to weak external demand and plant overhauls in oil and chemical industries. In addition, taxes on the export of goods to Kosovo and Metohija continue to hamper the recovery of manufacturing, particularly food industry. Compared to the pre-crisis period[23], economic activity in Q2 went up by 15.7%, measured by GDP, or by 19.3%, measured by NAVA.

After a relatively strong increase in Q1 (2.0% s-a), the physical volume of industrial production in Q2 recorded a fall of 1.6% s-a due to the reduced volume of production in manufacturing (2.3% s-a). This is largely attributable to external factors, primarily decelerated economic growth in the euro area. Plant overhauls in oil and chemical industries were behind the negative contribution of the physical volume of production in these two branches to quarterly trends of overall industry (0.8 pp). Furthermore, the volume of production of food products and beverages dropped from Q1 (3.6% and 5.2%, respectively), dragging the volume of industrial production down by 1 pp. On the other hand, a half of branches recorded an increase in the volume of production, with the largest positive contributions coming from the production of pharmaceuticals, computers and base metals.

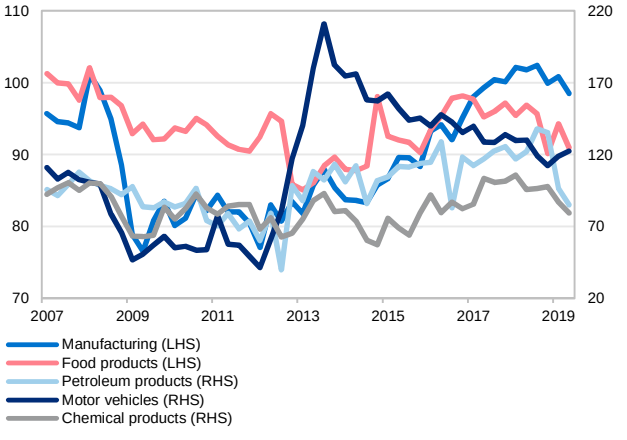
A mildly positive contribution to quarterly trends of the physical volume of production of the overall industry came from the electricity supply sector (0.1 pp) where the recovery initiated in Q1 continued and where the physical volume of production rose by 1.9% s-a in Q2. The physical volume of production expanded by 4.9% s-a in Q2 in mining as well, with intensified exploitation of coal and metal ore and weaker exploitation of oil.

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



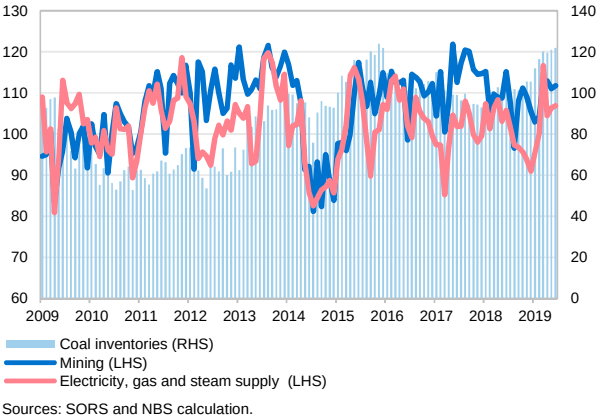
Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

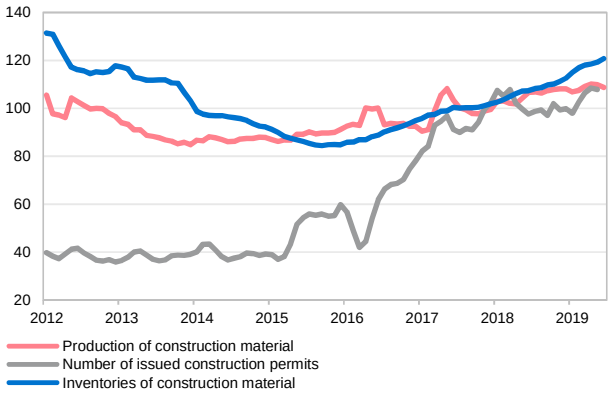
Chart IV.5.3 **Physical volume of production in energy and mining**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

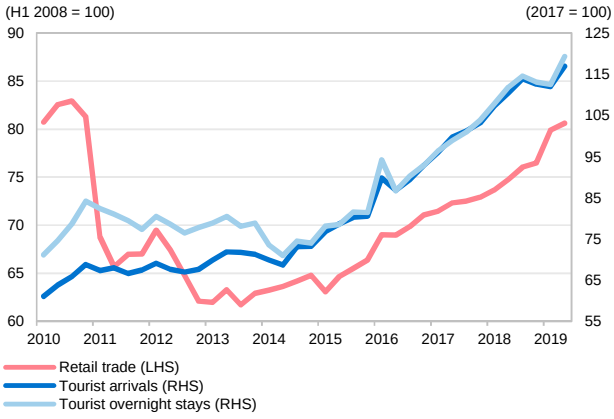
[23] Level from H1 2008.

Chart IV.5.4 **Construction activity indicators**
(quarterly averages s-a, 2017 = 100)



Sources: SORS and NBS calculation.

Chart IV.5.5 **Service sector indicators**
(s-a)



Sources: SORS and NBS calculation.

Table IV.5.1 **Contributions to y-o-y GDP growth**
(in pp)

	2018			2019	
	Q2	Q3	Q4	Q1	Q2*
GDP (in %, y-o-y)	**4.9**	**4.1**	**3.4**	**2.5**	**3.1**
Agriculture	0.8	1.2	1.0	-0.2	-0.2
Industry	0.5	-0.2	-0.6	-0.4	-0.4
Construction	0.8	0.4	0.1	0.4	0.9
Services	2.1	2.0	2.2	1.9	2.2
Net taxes	0.6	0.5	0.5	0.5	0.5

Sources: SORS and NBS calculation.
* NBS estimate.

Positive tendencies in the **construction** sector continued since, in our estimate, quarterly growth in Q2 accelerated to 8.0% s-a. This intense growth may be attributed to the accelerated implementation of infrastructure projects financed by the government and to the rise in private sector investments in the real estate market projects, as indicated by the rising number of construction permits in the first two months of Q2 (1.5% s-a). Rising activity in construction is also indicated by the rise in formal employment by 3.5% s-a.

We estimate that activity in **services** also intensified in Q2 to 1.4% s-a, led mainly by trade, transportation and tourism (2.0% s-a). This is also confirmed by retail trade which after a strong growth of 4.1% s-a in Q1, recorded in Q2 a s-a rise of 0.8%. Indicators in tourism also recorded positive developments – a quarterly rise in the number of tourist arrivals and overnight stays by 4.5% s-a and 6.0% s-a, respectively.

In y-o-y terms, GDP growth accelerated from 2.5% in Q1 to 3.1% in Q2, primarily on account of rising activity in services and construction which recorded 4.2% and 22% y-o-y growth, respectively. On the other hand, the production was lower in agriculture and industry. Industrial production did not recover in Q2 (2.6% fall y-o-y) due to the weakening of external demand from H2 of the previous year. The 3.4% y-o-y fall in agricultural production in Q2 is judged to be primarily a consequence of high base from the previous year when agricultural season was above-average.

Since we expect further acceleration of economic growth by the end of the year, our GDP growth projection for 2019 was kept at 3.5%. In addition to the pick-up in services and construction, we expect that industrial production will also bounce back and provide a positive contribution on account of the restored full volume of production in oil and chemical industries. On the other hand, preliminary data of the Statistical Office point to the lower wheat production (by 18.1%). As we still do not have the official estimate of the yield for other agricultural crops, we estimate that agriculture will fall in 2019 by around 5%, dragging GDP growth down by 0.3 pp. Since weather conditions were relatively favourable in June and July, agricultural production may prove to be even higher.

Text box 3: Total factor productivity and its contribution to Serbia's GDP growth

Total factor productivity (TFP) is typically used as a measure of an economy's efficiency and can be defined as the portion of output growth that cannot be attributed to the accumulation of capital and labour. Hence, the increase in TFP is both a measure of technological progress and a key factor of long-term economic growth and development, as it diminishes the significance of limitations stemming from the availability of production factors. Cross-country differences in TFP can largely be explained by a country's income level. Income convergence towards advanced economies therefore requires developing economies to have an accelerated TFP growth.

TFP is calculated by subtracting the weighted labour and capital inputs from the output growth, as follows:

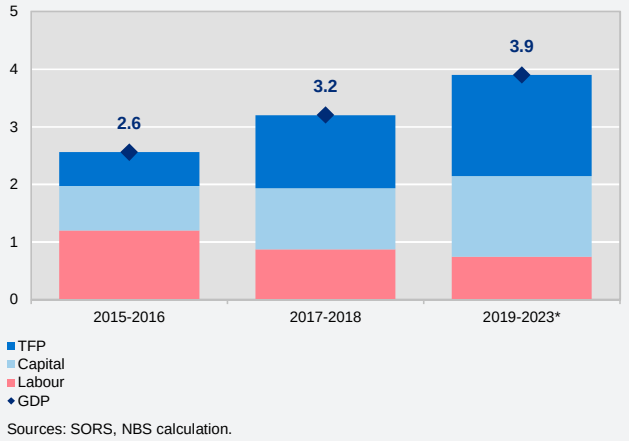
$$TFP = \frac{BDP_t}{BDP_{t-1}} - \alpha * \frac{L_t}{L_{t-1}} - \beta * \frac{K_t}{K_{t-1}}$$

where weights α and β are the output elasticities of labour (L) and capital (K) generated from the standard Cobb–Douglas production function.

To determine the labour input, we used data on registered employment from the Central Registry of Mandatory Social Insurance and unregistered employment from the Labour Force Survey. For the calculation of capital input, an initial capital level was determined, as the product of the average ratio of capital and GDP for other countries with similar development and GDP levels, adjusted for the depreciation rate and the real return on equity rate.[1] Capital was increased by the amount of fixed investments and decreased by depreciation for each year to come. In addition to econometric assessment of labour productivity dependence on technical labour equipment, what is also used to calculate output elasticity α is the share of total wage bill in GDP. When output elasticity α for Serbia was calculated, what was taken into consideration was the share of total wage bill in GDP including the estimated portion of workers' income not paid into their current accounts and a portion of income generated by farmers[2]. Output elasticity of labour calculated in this way averaged 0.6 for the past six years.

Observing the period since 2015, based on above stated relation, it can be concluded that labour and capital as well as total factor productivity, i.e. output efficiency increase are a positive contributor to GDP growth. The results of the analysis indicate that productivity gains in 2017 and 2018 supported the acceleration of GDP growth. On the other hand, though positive, the joint contribution of labour and capital to GDP growth stayed unchanged from 2015–2016, while slower employment increase was offset by the faster capital growth.

Chart O.3.1 **Contribution to y-o-y GDP growth**
(period average, in pp)



Sources: SORS, NBS calculation.
* NBS estimate.

New production technologies significantly account for the productivity rises, with significant contribution from FDIs which recorded an aggregate increase of around EUR 10 bn in this period. Namely, despite their direct impact on the investment level, the FDIs indirectly affect employment as well as TFP by transfer of new technologies and know-how. Important for economic growth sustainability is the fact that since 2015 one third of total FDI inflows went to manufacturing (EUR 3 bn) boosting its exports which went up by 50% until 2018 (from around EUR 10 bn in 2014 to around EUR 15 bn in 2018).

[1] The 25% share of investments in GDP, 6% return on equity rate and 5% depreciation rate.

[2] According to the methodology in R. Feenstra, R. Inklaar, and M. Timmer (2015), "The Next Generation of the Penn World Table", American Economic Review, 105(10): 3150–3182.

The projection for 2019–2023 period is that labour will continue to provide a positive contribution to GDP growth, but less so than in the previous years. Such developments can be attributed to the lower unemployment rate and to relatively unfavourable demographic trends, while the rise in the participation rate, i.e. people's stronger willingness to work, have an opposite effect. On the other hand, we estimate that rising investments, on account of structural reforms, will increase the contribution of capital as well as of TFP to GDP growth, and that the contribution of productivity will reach 2 pp. Taking this into account, we expect that Serbia's convergence towards income levels of advanced countries will accelerate in the coming period and that economic growth will be sustainable in the long run.

6 Labour market developments

Labour market conditions improved further in Q2 – the upward trend of the average wage continued in April and May and so did the downward trend of unemployment which fell to its lowest level. Formal employment continued growing, though at a slower pace than in the past two years, supported by the further pick-up in economic growth, which also bolstered the overall economic productivity.

Wages and labour productivity

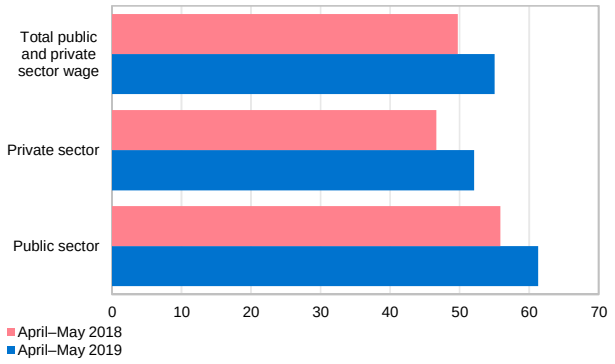
Favourable labour market trends in the recent years persisted in April and May as confirmed by the rise in total nominal net wage of 10.6% y-o-y, driven by the further improvement in the overall economic productivity. Nominal net wages in the public sector[24] increased (9.7% y-o-y), while private sector wages rose (11.5% y-o-y) also on account of a positive and better company financial result in 2018. The average nominal net wage in April and May was RSD 55,013, or EUR 466. After the January increase in the minimum wage (from RSD 143.0 an hour to RSD 155.3 an hour), the possibility for another rise this year was announced.

In y-o-y terms, **the rise in the nominal net wage in April and May remained broad-based**. Information and communications, mining, energy and financial sectors recorded the most pronounced growth. Furthermore, nominal wages rose in services, construction and manufacturing where the private sector is dominant, while higher wages in health and social protection, public administration, and education are a result of the public sector wage increase.

Employment and wage increase in the private sector and higher public sector wages pushed the total nominal net wage bill up by 14.8% in April and May relative to the same period last year.

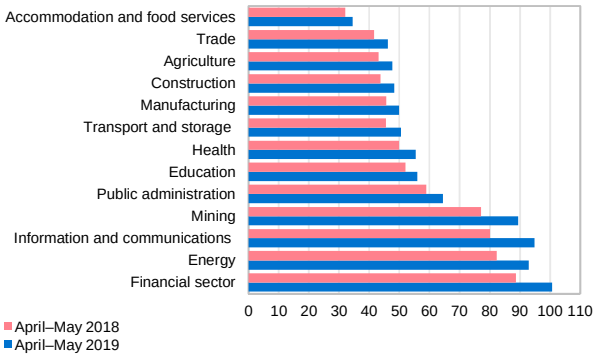
Our estimate is that the overall economy recorded a productivity rise of 1.4% y-o-y in Q2 as GDP grew faster than employment. Unlike the past period when incentives were aimed at projects fostering employment, now the incentives are used to attract FDIs into projects that create higher value added of the final product, which should contribute to a faster rise in productivity in the period ahead.

Chart IV.6.1 **Average nominal net wage**
(in RSD thousand)



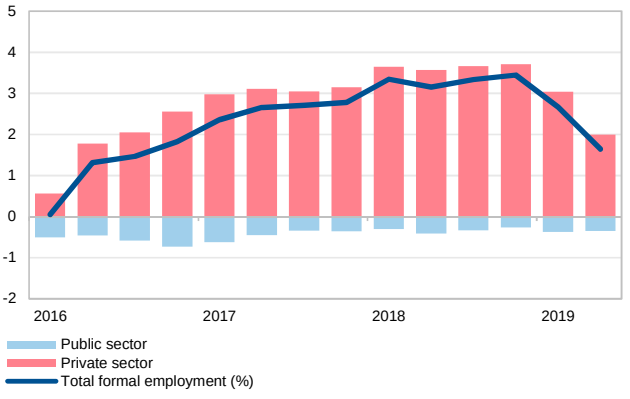
Source: SORS.

Chart IV.6.2 **Nominal net wage by economic sector**
(in RSD thousand)



Source: SORS.

Chart IV.6.3 **Composition of y-o-y rise in total formal employment**
(in pp, period average)



Sources: SORS and NBS calculation.

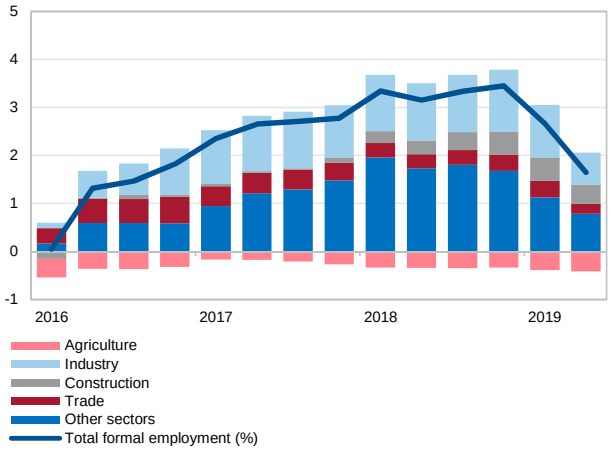
[24] For the purposes of average wage calculation, the Statistical Office classifies the following in the public sector: state-owned enterprises, municipally-owned enterprises, all levels of administration, public institutions engaged in health and social protection, educational and cultural activities.

Table IV.6.1 **Formal employment and unemployment**
(y-o-y growth rates, period average)

	2018		2019	
	Q3	Q4	Q1	Q2
Total number of formally employed	3.3	3.4	2.7	1.6
Employed with legal persons	3.2	3.4	2.6	1.9
Entrepreneurs and their employees	6.7	6.4	5.3	2.8
Individual farmers	-8.2	-8.3	-8.3	-8.7
Unemployed	-10.5	-10.8	-9.1	-9.3
First-time job seekers	-10.9	-11.5	-1.6	21.1
Used to be employed	-10.3	-10.5	-12.7	-24.3

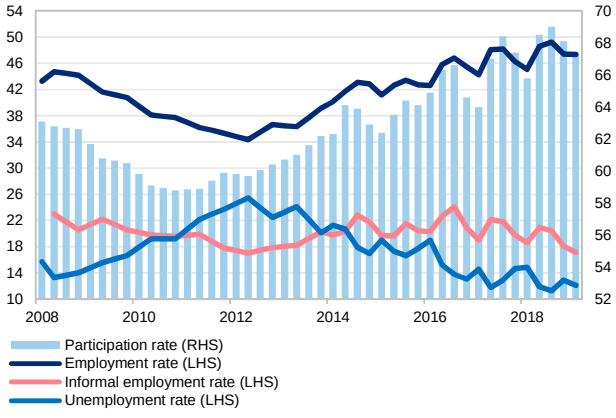
Sources: SORS and National Employment Service.

Chart IV.6.4 **Contribution to y-o-y growth in total formal employment by economic sector**
(in pp, period average)



Sources: SORS and NBS calculation.

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



Source: SORS.

Employment

Formal employment decelerated and its y-o-y growth measured 1.6% in Q2. The reasons behind such dynamics are a continued unemployment drop, as well as the relatively high rates of formal employment in the previous periods. According to Statistical Office data obtained from the Central Registry of Mandatory Social Insurance, **formal employment in Q2 rose on account of continued employment with legal persons and entrepreneurs**, while the reduction in the number of individual farmers worked in the opposite direction.

As in the previous quarters, the rise in formal employment in Q2 was driven by increasing private sector employment. Manufacturing recorded a significant number of new recruits in Q2, followed by construction, trade and a whole range of services which contributed the most to economic growth. Mining and water supply sectors also had a higher number of newly employed persons. On the other hand, agriculture and energy sectors saw a further drop in employment, as did the health and social protection and public administration, due to the continued public sector downsizing process[25].

The rise in formal employment was accompanied with a further fall in registered unemployment in Q2, as a result of improved business and investment conditions in our country, as well as the implementation of active labour market policies[26]. According to the National Employment Service, **unemployment fell to its new historical low, since comparable records exist**, with 527,208 people registered as unemployed in June, down by 51,864 from the same period last year. In addition, the number of the unemployed decreased on average by around 226,000 in Q2 relative to the same period of 2012. In y-o-y terms unemployment dropped in all occupational groups, primarily those related with manufacturing, trade, catering and tourism, as well as occupations in agriculture, construction and transportation.

Available **LFS** data for Q1 also suggest that labour market dynamics are positive. This is primarily observable in the case of the persistently high participation rate of working age population (15–64) which reached 67.2% in Q1, up by 1.4% pp from the same period of the year before. The employment rate was kept at Q4 level (47.4%), up by 2.3 pp compared to the last year's level, while in y-o-y terms the unemployment rate

[25] Pursuant to the Law on Ceilings on the Number of Public Sector Employees.

[26] Active labour market policies entail: job matching services, career guidance and counselling, support to self-employment, further education and training, special programmes for youth in transition from the education system to the labour market, etc.

dropped by 2.7 pp to 12.1% in Q1. This is entirely consistent with the rise in formal employment as in Q1 informal employment touched its lowest level (17.1%) since comparable data are available. Long-term unemployment rate at 7.1% is also close to its historical low. In y-o-y terms, Q1 saw a reduction both in the youth unemployment rate (15–24) – by 3.9 pp to 30.7% and in the NEET rate, by 2.6 pp, to 14.7%.

7 International environment

Global growth continued at a slower pace in H1 2019, mainly owing to the slackening of global trade and investment, wherefore leading international institutions assessed that the risks to the growth projection remain skewed to the downside. After accelerating in Q1, euro area GDP is likely to trend at a weaker pace in the remainder of the year, while economic activity will continue to be supported by macroeconomic fundamentals over the medium term. In the short term, the US economy is also expected to slow down, with continued positive developments in the labour market. With stable domestic demand still supportive of economic growth in the region of Central and Southeast Europe, growth forecasts for the coming period remain optimistic.

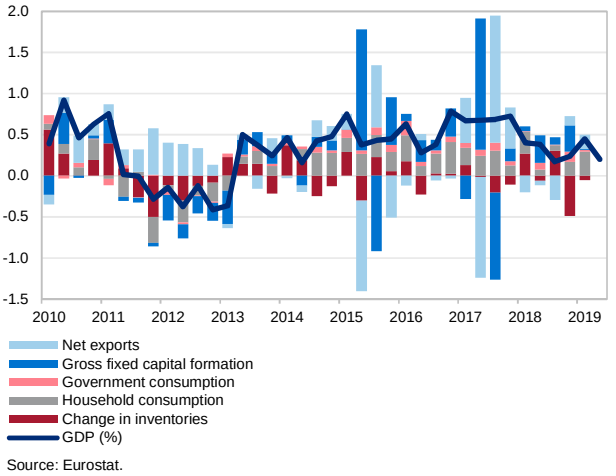
Inflation at the global level is still moderate. Inflationary pressures remain low in the majority of advanced economies, while inflation continues to trend below the target. Since the start of 2019, inflation in Central and Southeast Europe had an upward trend, driven by food and energy prices, only to slow down in most of the countries in June, in response to declining global oil prices.

Leading central banks announced additional monetary stimuli in conditions of slower global growth and somewhat poorer prospects for the coming period, with the Fed trimming its interest rate at end-July for the first time since 2008. Coupled with the fall in bond yields and positive developments in the stock exchange, this helped sustain favourable global financial conditions.

Economic activity

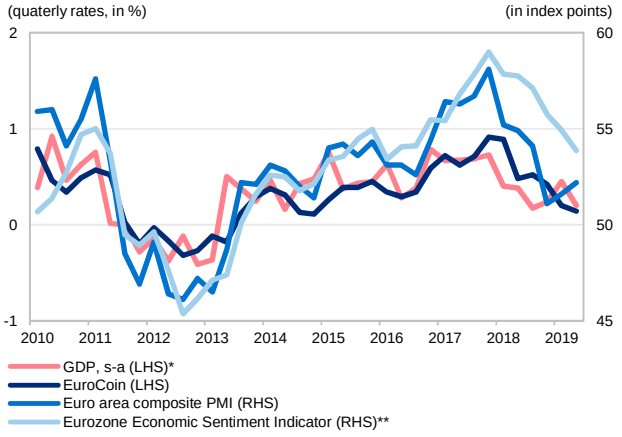
In July, the IMF stated that **global growth is still sluggish**. In the period since the previous report, the USA and China introduced additional tariffs on their goods trade, the uncertainty surrounding Brexit is still present, and geopolitical tensions have continued. The

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



Source: Eurostat.

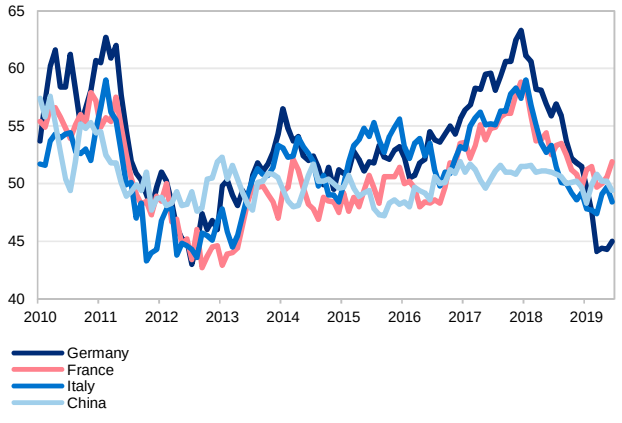
Chart IV.7.2 **Movements in GDP and economic activity indicators of the euro area**



Sources: Eurostat, Markit Group, Banca d'Italia and European Commission.

* Eurostat's preliminary flash estimate for Q2 2019.
** ESI is standardised relative to PMI.

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



Source: Markit Group.

growth of advanced economies in Q1 surprised on the upside, and that of emerging markets on the downside. Another indication of a slowdown in world economy is the Global Manufacturing PMI, which dropped to 49.4 in June, its lowest level since October 2012. At the same time, business conditions worsened due to stagnating production and a slump in new orders. In such conditions, the IMF revised its global growth projections slightly down relative to April – by 0.1 pp to 3.2% in 2019 and 3.5% in 2020.

After decelerating in H2 2018, growth of the **euro area GDP** in Q1 2019 accelerated more than expected, reaching 0.4% s-a owing to investments in fixed assets and private consumption triggered by declining unemployment and wages rising at the fastest rate in ten years. Despite external challenges, net exports gave a positive contribution. According to the **ECB's** estimate, economic recovery in the euro area in Q1 can be partly attributed to the effects of specific factors. Thus, the 0.4% s-a rise in Germany's GDP in Q1 was higher than expected (driven by private consumption), while Italy's GDP rise of 0.1% s-a is attributable to economic recovery. In addition, some countries recorded growth in external demand from the UK in anticipation of the Brexit date.

Leading indicators of economic activity pointed to poorer growth in Q2. Due to global uncertainty, the Economic Sentiment Indicator for the euro area in Q2 recorded the lowest level in three years and on average equalled 104.1 points.[27] Relative to Q1, the PMI Composite for the euro area in Q2 was slightly higher (51.8 points[28] on average), with continued diverging movements – subdued economic activity in manufacturing as opposed to more favourable conditions in the services sector and construction. According to Eurostat's flash estimate, economic activity in the euro area in Q2 rose at the same (slow) rate as in H2 2018 (0.2% s-a). Relative to the production sector, positive developments in the euro area labour market in Q2 are more evident, given that the unemployment rate declined in June to its lowest level in 11 years – 7.5%.

According to the **ECB's June forecast**, economic growth in the euro area is expected to unfold at a slower pace until the end of the year, especially in terms of export-oriented sectors, under a dominant impact of

[27] The index has been designed to indicate long-term average with 100 points.

[28] Index value above 50 points indicates expansion, and below 50 a decline in economic activity.

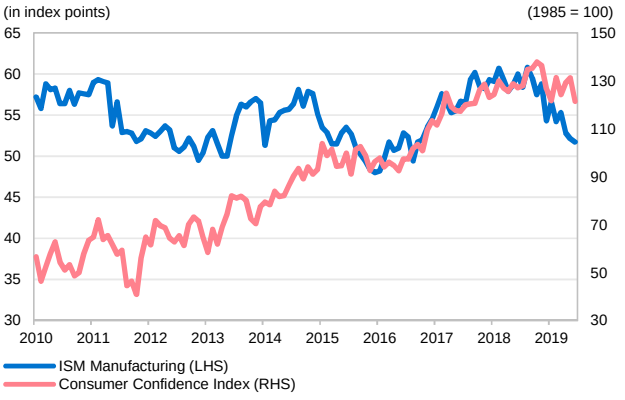
global factors (possible escalation of protectionism and failure of the UK and EU to reach an exit deal). Still, economic growth in the medium term should continue to be supported by domestic macroeconomic fundamentals, primarily the expansionary monetary policy, rising wages and fiscal breaks, with a gradual recovery of external demand. In June, due to faster growth in Q1, the ECB revised its growth projection for euro area GDP for 2019 slightly up (by 0.1 pp to 1.2%), while growth in 2020 and 2021 is expected to be lower than three months ago and measure 1.4% for each year.

US economic growth sped up to 0.8% s-a in Q1, i.e. 3.1% annualised (from 2.2% in Q4), with a positive contribution of all components on the expenditure side, notably net exports (0.9 pp). According to the estimate of the Bureau of Economic Analysis, US growth slowed down to 2.1% annualised (0.5% s-a) in Q2, largely in response to a fall in exports and investment. Due to the anticipated weaker investment dynamics, the Fed stated in June that it maintained the GDP growth projection for 2019 at 2.1%, forecasting a slower pace of economic growth in the remainder of the year. Medium-term projections were almost unchanged – growth estimate for 2020 has been revised slightly up (by 0.1 pp to 2.0%), while the projection for 2021 remained the same (1.8%).

According to the US Bureau of Labor Statistics, the labour market still boasts favourable developments given that the average unemployment rate in Q2 dropped to 3.6%, its lowest level in 50 years. Also, the participation rate (62.8%) and the employment rate (60.6%), on average, remained relatively high during Q2. The Fed also pointed out the stable conditions in the labour market, adding that by 2021 the unemployment rate will be below its natural level and that the benefits of rising employment will increase the share of active population more strongly.

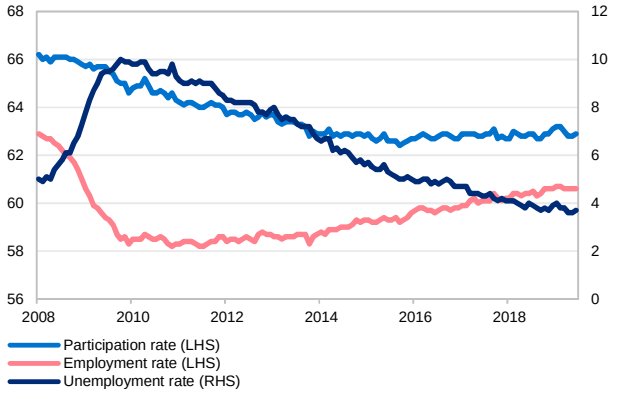
Despite the still weak growth impulse in the euro area, economic activity in **Central Europe** continued to rise in Q1. Hence, the Consensus Forecast revised the region's growth in 2019 up to 3.8% from the 3.5% projected in April. The current decisions of the ECB and Fed alleviated concerns over liquidity in the international financial market and stimulative financial conditions. The admirable performance in the region was also confirmed by improved economic conditions in Poland and Hungary, where growth in Q1 accelerated relative to Q4 to 4.7% and 5.3% y-o-y respectively. Solid economic growth in Central European countries will continue to be propped by EU funds, favourable financial conditions and rising wages.

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



Sources: Institute for Supply Management, Conference Board.

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



Source: Bureau of Labor Statistics.

The region of **Southeast Europe** also posted a positive growth rate, largely on account of higher wages which encourage private consumption. Such movements drove the Consensus Forecast to revise up its April growth projection in July – by 0.4 pp to 3.5% in 2019, and by 0.1 pp to 2.9% in 2020. In this regard, growth projections for the majority of countries in the region were revised up, notably for Romania, whose y-o-y growth accelerated strongly (from 4.1% in Q4 to 5.0% in Q1) propped by domestic demand. On the other hand, trade and geopolitical tensions, as well as the slower euro area growth, could dampen the prospects for future growth.

After posting a 2.7% y-o-y growth in Q4, **Russia's GDP** slowed down considerably in Q1, to 0.5% y-o-y, according to Rosstat's flash estimate. This is largely attributable to subdued consumption and investment activity on account of a VAT increase as of January 2019 and monetary tightening that kicked in as of H2 2018. Lower external demand and capped oil production acted as an additional drag on GDP growth. Even so, these effects are ascribed to temporary factors and the recovery of Russia's economic activity is projected for Q2 thanks to the completion of national projects and public investments. In addition, Q1 saw the Russian economy post the highest financial result in 12 years, with unemployment dropping to a historic minimum of 4.5% and nominal wage growth reaching 7.7% y-o-y in March.

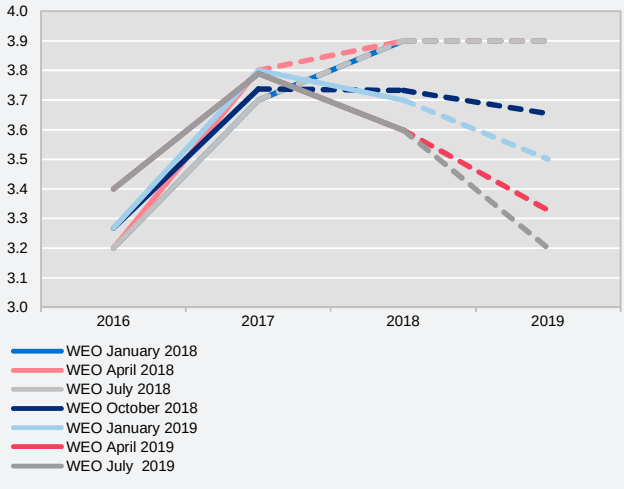
In Q1, the **Chinese economy** upheld its growth from the previous quarter, measuring 6.4% annualised. Growth was driven by capital investment, while a stable pick-up in the services sector made up for the sluggish industrial activity. The preliminary growth estimate of 6.2% in Q2 suggests slower GDP growth in H1. According to the Bank of China Institute of International Finance, this is due to the weaker global recovery and the US-China trade stand-off. The IMF also stressed that weaker external demand creates additional pressure on the Chinese economy which is faced with structural slowdown and the need for fiscal stimuli. This is why the government will continue to trim taxes, implement infrastructure projects and improve its investment climate, while the banking sector will keep providing support to micro and small enterprises.

Text box 4: Changes to the global growth outlook

As the 2017 global growth surprised on the upside, accelerating in all leading regions of the world, the expectation for early 2018 was that positive tendencies would continue in the coming period. Investments and trade were on the rise, unemployment was declining in the USA, Europe and Japan, and low inflation throughout the world allowed for the preservation of favourable financing conditions. All of this boosted confidence and attracted capital inflows to emerging markets. It was expected that, in addition to the domestic demand, the positive impact of external demand on account of faster economic growth of its most significant trading partners (the USA and East Asia countries) would also contribute to the robust growth pace of the euro area, our most significant trading partner. All relevant international institutions revised upwards their global growth projections for 2018 and 2019. These projections indicated that advanced economies would continue to grow at above-potential rates, additionally spurred by new fiscal measures adopted in February in the USA which would bolster the domestic demand and spill over to other economies. In such an environment, the Fed was expected to continue and the ECB to commence the monetary policy normalisation.

However, the introduction of protectionist measures, after a few decades of global trade liberalisation, made the risks to the downside more pronounced even in the short run. With somewhat slower growth of China, higher energy prices and intensified uncertainty surrounding economic policies in the coming period, the rising trade barriers decelerated the global trade. In its July WEO update, the IMF stressed that economic growth became less synchronized across countries, with the US growth proving more robust in the short run, while growth projections for the euro area, Japan, the UK and some emerging economies, like the Argentine, Brazil and India were revised downwards.

Chart O.4.1 **IMF global real growth projections for 2018 and 2019**
(in %)



Source: IMF WEO.

Table O.4.1 **Euro area growth forecast**
(in %)

ECB	Dec. 2017	March 2018	June 2018	Sept. 2018	Dec. 2018	March 2019	June 2019
2018	2.3	2.4	2.1	2.0			
2019	1.9	1.9	1.9	1.8	1.7	1.1	1.2
IMF WEO	Jan. 2018	April 2018	July 2018	Oct. 2018	Jan. 2019	Apr. 2019	July 2019
2018	2.2	2.4	2.2	2.0			
2019	2.0	2.0	1.9	1.9	1.6	1.3	1.3
World Bank	Jan. 2018		June 2018		Jan. 2019		June 2019
2018	2.1		2.1				
2019	1.7		1.7		1.6		1.2
Consensus Forecast	Jan. 2018	April 2018	July 2018	Oct. 2018	Jan. 2019	Apr. 2019	July 2019
2018	2.2	2.4	2.2	2.0			
2019	1.8	1.9	1.8	1.8	1.5	1.1	1.1

Sources: ECB, IMF, World Bank and Consensus Forecast.

The above risks, rising protectionism in foreign trade, shift in capital flows toward emerging economies with weaker economic indicators and heightened geopolitical tensions made most of relevant institutions reduce their projections since October 2018, now largely expecting global growth for 2018 and 2019 to the level recorded in 2017. The stance of monetary policies of leading central banks, which still suggested the continuation of monetary policy normalisation, also contributed to the downward revision of growth projections. Such a turn of events might have jeopardised the position of emerging economies with considerable external financing needs and might have weakened their currencies. The majority of economic groups ended the year with lower growth. Also, at the end of the year signals appeared that monetary policy normalisation of leading central banks might be slower than expected.

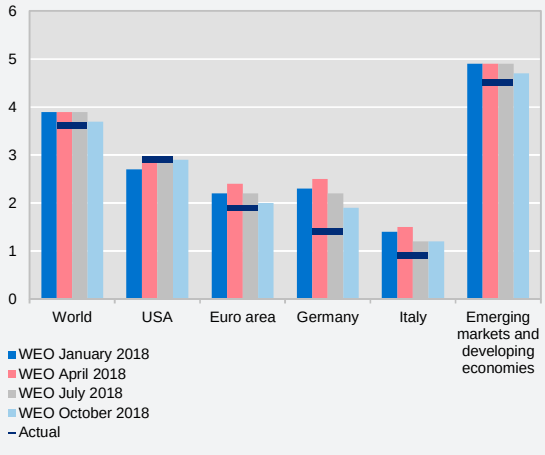
In early 2019 the global growth outlook deteriorated again and the majority of relevant institutions no longer expected closely the same, but slower global growth relative to last year's. In January, the IMF again revised the global growth

projections downwards, due to the expectation of a continued slowdown in economic activity from H2 2018, uncertainties surrounding the global trade policy and worsened investor sentiment. The slowdown in advanced countries unfolded sooner than expected and the contraction in economic activity in Turkey and Argentina, as well as the impact of protectionist measures on China's economic growth, undermined the economic outlook of emerging markets. In 2019, the IMF, World Bank and Consensus Forecast revised the euro area growth downwards, primarily due to the softening external demand, lower automobile industry output caused by the introduction of new standards on gas emissions in Germany and weaker aggregate demand in Italy amid concerns over public debt sustainability. It has also been estimated that projection risks are skewed to the downside, primarily on account of a possible further rise in global trade tensions.

The above factors continued to constrain growth in the spring of 2019 and the IMF reduced the global growth outlook for 2019 again (this time to 3.3%), stating that 70% of the global economy would slow down due to the weak beginning of the year, while H2 would be more favourable, as the influence of the said factors waned. Slower than expected monetary policy normalisation of leading central banks was also estimated to contribute to favourable trends in H2. In March, the ECB revised the euro area growth downwards, as did the Consensus Forecast and the IMF, with the IMF projection being somewhat more optimistic.

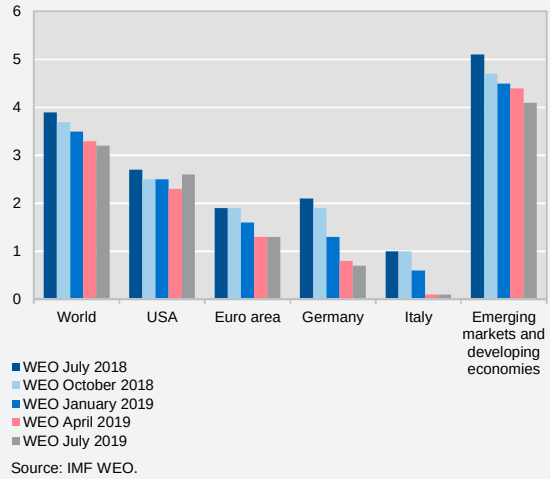
In recent months the risks to the global economic growth heightened additionally – in May the USA raised their tariffs on some goods from China and China responded with retaliatory measures, while the possibility for a no-deal Brexit also increased. Along with the slowdown in global trade and industrial production, this led all relevant institutions to forecast the deceleration of the global economic growth for this year, while the shift of leading central banks towards new monetary policy incentives coupled with the rise in the domestic demand of China under the influence of recent measures should bolster the recovery in 2020. The IMF is projecting global growth acceleration for 2020, but it largely depends on the fulfilment of several assumptions such as the preservation of favourable financial conditions, waning of the temporary factors which caused the euro area slowdown, etc. In June, the ECB revised euro area growth projection slightly upwards (from 1.1% to 1.2%) on account of higher than expected growth in Q1, with the anticipation of growth acceleration in 2020, as also forecast by the Consensus Forecast and IMF.

Chart O.4.2 **Adjustment of real GDP growth forecast for 2018 by IMF**
(in %)



Source: IMF WEO.

Chart O.4.3 **Adjustment of real GDP growth forecast for 2019 by IMF**
(in %)

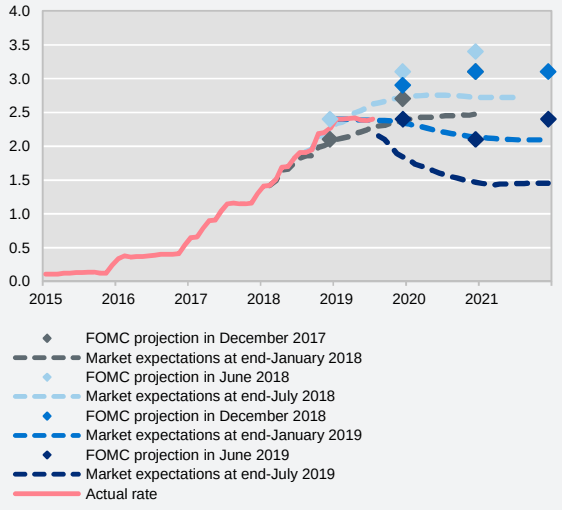


Source: IMF WEO.

The changes to global growth outlook last year and since the beginning of this year made defining the assumptions for central banks' macroeconomic projections more challenging. Despite the fact that deteriorated global growth outlook is a direct downside risk to GDP projections of individual countries, as they indicate a slowdown in external demand, they also indirectly affect GDP and inflation projections through their impact on other macroeconomic indicators, primarily the prices of oil and other primary commodities, global risk premium and capital flows. The slackened global economic growth has been containing a higher rise in the prices of oil for some time now. The further slowdown, primarily of China, which

has become the main driver of demand for primary commodities in the global market, would additionally decelerate the demand for those commodities. The potential effects on this account for Serbia, as an oil importer, would be positive in terms of its economic growth, reflected primarily through the higher disposable income and lower operating costs. At the same time, a disinflationary impact would come through lower prices of petroleum products in the domestic market. In the case of falling prices of primary agricultural commodities on account of lower global growth, the impact on inflation would be the same due to reduced costs in food production. Since Serbia is an exporter of agricultural commodities, the effect on economic growth would probably be the opposite to the case of lower oil prices. The slower global economic growth has a negative influence on global risk premium and investor sentiment which in turn can have a negative impact on the global capital flows. However, these effects can be offset or even overpowered by the positive effects of monetary policy easing of leading central banks which largely depend on the global growth outlook. More favourable conditions in the international financial market on this account should reflect positively on investor sentiment, risk premium, capital flows to emerging economies and stability in their FX markets.

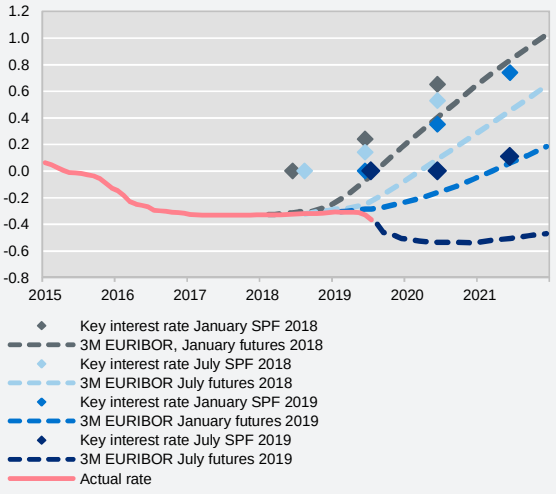
Chart O.4.4 **Expected Fed funds rate***
(p.a, in %)



Sources: Fed and Bloomberg.

* Market expectations based on futures.

Chart O.4.5 **Expected ECB key interest rate* and futures for three-month EURIBOR**
(p.a., in %)

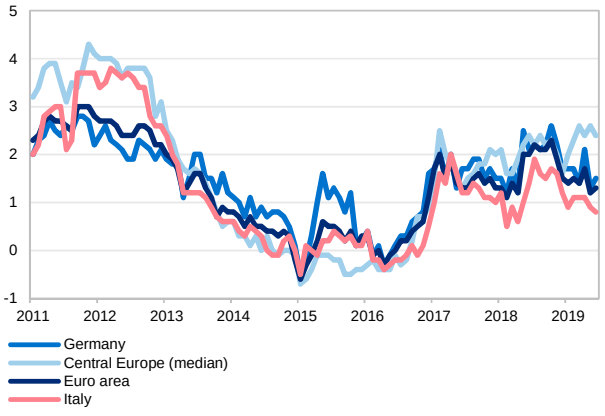


Sources: ECB and Bloomberg.

* ECB Survey of Professional Forecasters (SPF).

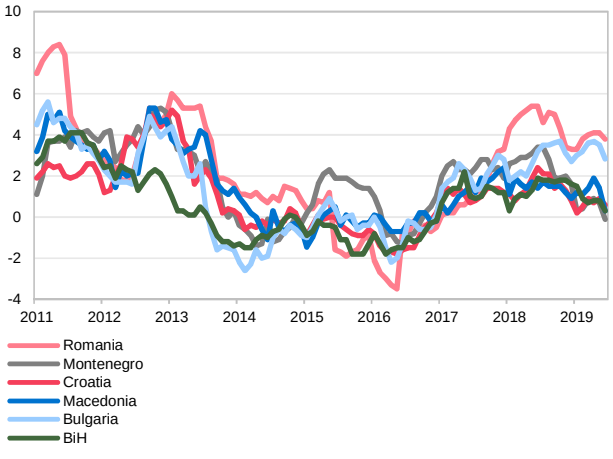
The ultimate impact of the said factors from the international environment on Serbia – external demand, global primary commodity prices, and global financial conditions – will depend on their interaction, and to a significant degree, on the domestic factors. It is precisely the domestic factors, primarily robust investment growth supported with higher government capital spending (which reached 4% of GDP already in 2018, and that was a medium-term goal), favourable borrowing conditions, high FDI inflow and the rise in the corporate profitability, that helped offset the effects of lower external demand and made Serbia record in 2018 the highest economic growth in the last ten years. This is why it is so important that Serbia has attained macroeconomic stability and achieved significant structural improvements, reduced internal and external imbalances, strengthening its resilience to external shocks and, at the same time, the ability to exploit the positive external impulses.

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



Source: Eurostat.

Chart IV.7.7 **Movement in the Consumer Price Index for selected countries**
(p.a., in %)



Sources: Statistical offices in several countries.

Inflation movements

Though average y-o-y inflation in the **euro area** in Q2 remained unchanged (1.4%), it was more volatile than in Q1. After reaching 1.7% in April, it declined to 1.2% in May, mainly owing to the lower prices of energy and services, only to edge up to 1.3% in June on the back of a recovery in the prices of services. Average y-o-y core inflation picked up slightly, from 1.0% in Q1 to 1.1% in Q2. Cost-push pressures continued to strengthen amid high utilisation of capacities and declining unemployment. This is also confirmed by data on the further rise in negotiated wages of 2.2% y-o-y in Q1. According to Eurostat's flash estimate, total y-o-y headline inflation in the euro area in July slowed down to 1.1%, and core inflation to 0.9%. In the medium term, the ECB expects core inflation to rise gradually, driven by monetary policy accommodation, as well as by extended, albeit slower, economic growth and rising wages. As for Serbia's main foreign trade partners, average y-o-y inflation, measured by the Harmonised Index of Consumer Prices, equalled 1.6% in **Germany** in Q2 (the same as in Q1), whereas it dipped slightly in **Italy**, from 1.0% to 0.9%.

Since the start of 2019, inflation in the **Central and Southeast European region** trended up, driven by the increased food and energy prices, however, it slowed down in most of the countries in June, responding to the fall in global oil prices. The rise in wages and domestic demand continued to generate moderate inflationary pressures in these countries, while lower import inflation acted in the opposite direction. After reaching its highest level in Q1 since the start of 2017 (5.2%), average y-o-y inflation in **Russia** declined to 5.0% in Q2, owing to the rouble gaining strength since the start of 2019, as well as to subdued consumer demand. In Q2, inflation in **Turkey** continued to decelerate, coming down from 19.9% y-o-y in Q1 to 18.0% y-o-y on average in Q2. In June it reached its lowest level in the past year (15.7% y-o-y) as a result of past monetary tightening and weak demand, as well as the high base effect.

Measured by the personal consumption expenditure price index, headline inflation in the **USA** in Q2 remained unchanged relative to Q1 (1.4% y-o-y on average). Excluding food and energy prices, inflation declined slightly, from 1.6% y-o-y on average in Q1 to 1.5% y-o-y in Q2, undershooting the 2% target. Inflationary pressures at home are still low, bearing in mind that wages do not rise at the rate that could push inflation up, while global disinflationary pressures are also still present.

Monetary policy

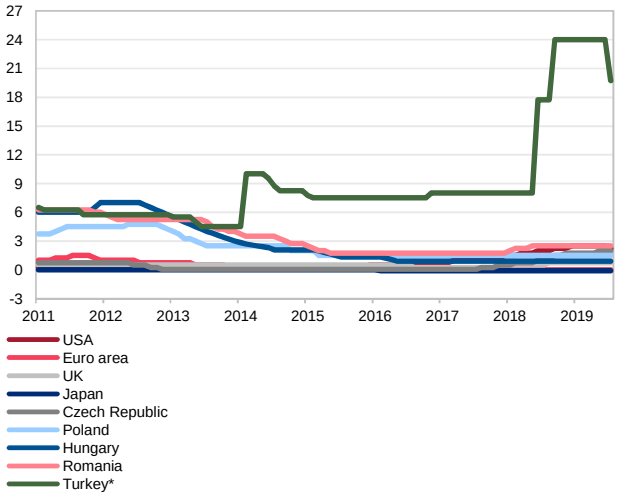
At the end of Q2, leading central banks announced new monetary stimulus in an environment of low inflation and heightened risk of an additional economic slowdown. In order to ensure sustainable inflation movements towards the target of below, but close to 2% over the medium term, the **ECB** additionally changed its forward guidance on the interest rates at the June meeting to indicate expectation that rates will stay unchanged at least through H1 2020, instead of through 2019. Also, the ECB will continue reinvesting the principal payments from maturing securities under the asset purchase programme past the date when it starts raising its key interest rate, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation. Moreover, the ECB specified the terms for a new series of quarterly targeted longer-term refinancing operations (TLTRO-III), each with a maturity of two years, which will be in place from September 2019 until March 2021.

In its July meeting, the ECB decided to keep interest rates on hold, though this time it underlined the possibility of lowering them by mid-2020, and expressed readiness to introduce additional measures amid poor inflation outlooks. Also, for the first time, the press release mentioned the symmetry in the inflation target relative to the 2% level.

The **Fed** kept its target range at 2.25–2.50% during Q2 as well, though rising uncertainty in terms of the growth outlook and muted inflationary pressures led to a fall in expectations regarding future movements of the federal funds rate, which resulted in a turn in the Fed's communication. In his regular semi-annual report to the Congress, the Fed Chairman voiced his concern over trade tensions, the UK's EU exit, dampened growth in advanced economies and spill-over effects on US economy. He also stressed that, after inflation trended below the target during H1, there was a risk of it remaining low longer than previously expected. Such backdrop gave rise to expectations that the Fed would lower its interest rate, which was indeed decided in a meeting at end-July, when the rate was trimmed to 2.00–2.25%, its first cut since 2008. In addition, a decision was made about completing balance sheet normalisation in August, two months ahead of the original plan.

The change in the character of leading central banks' monetary policies alleviated the pressure on central banks in the region towards monetary policy tightening.

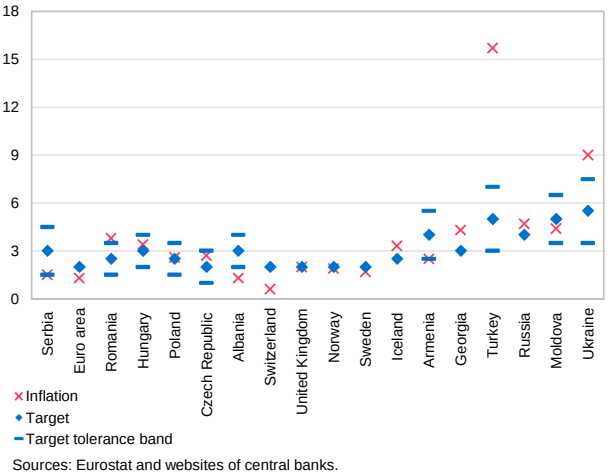
Chart IV.7.8 **Policy rates across selected countries**
(p.a., in %)



Sources: Central banks of selected countries.

* As of June 2018, after a year and a half, the one-week repo rate is again the key policy rate.

Chart IV.7.9 **Inflation and target by country in June 2019**
(p.a., in %)



Sources: Eurostat and websites of central banks.

In Q2, the central bank of **Hungary** kept its key policy rate at 0.90% and its overnight deposit facility rate at -0.05%, maintaining a cautious monetary policy stance. Though stepped-up demand at home and good labour market performance are pushing inflation up, subdued economic performance in euro area is expected to have a restrictive effect on price growth. Accordingly, core inflation excluding indirect tax effects is expected to rise until the end of the year, from the current 3.5% y-o-y in June, only to start declining gradually thereafter, towards the 3% target, on account of external disinflationary pressures.

As in Q1, the central bank of **Romania** kept its key policy rate at 2.50% in Q2, with officials stating that it might still be increased further given that inflation is expected to remain above the target until end-2019. In accordance with analysts' expectations, the central bank of **Poland** kept its key policy rate on hold at 1.5%, where it has stood since March 2015. The **Czech** central bank was the only one to raise its key policy rate, by 25 bp to 2.00%, as anticipated by analysts.

Though it kept its key policy rate unchanged in Q2, amid the still high inflation, the central bank of **Turkey** temporarily suspended one-week repo operations at the rate of 24% in May, for the second time this year, thus turning banks towards costlier lending facilities at the rate of 25.5%. However, at end-May, the central bank resumed its main instrument, thus neutralising this effect. In late May it also raised the FX reserve requirement ratios by 200 bp. The key policy rate was trimmed by 425 bp at end-July, to 19.75%, which exceeded the expectations of analysts and at the same time represented the largest key policy rate cut in the inflation targeting regime, i.e. since 2002.

As the effect of the VAT increase that kicked in on 1 January 2019 was already fully transferred onto prices, and given the poorer-than-expected economic growth and the relatively more favourable external conditions, the central bank of **Russia** lowered its key policy rate in June, for the first time since March 2018, bringing it down from 7.75% to 7.50%, and then trimmed it once again in July to 7.25%. Inflation projection was revised down and the possibility of key policy rate cuts at upcoming meetings was mentioned, with the note that the monetary policy will take up a neutral stance until mid-2020.

Financial and commodity markets

The upward trend of the value of shares, present since the start of the year, was disrupted in May due to new protectionist measures by leading world economies,

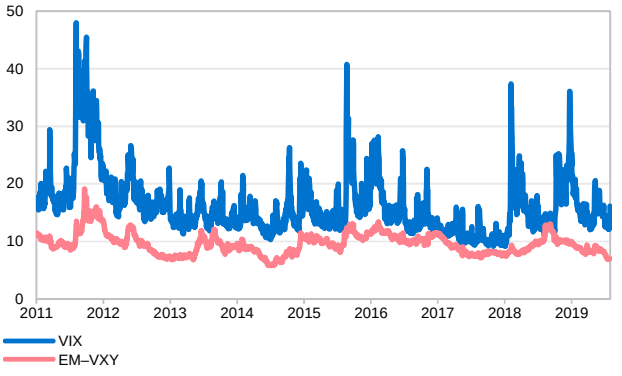
which spurred concerns of market participants in terms of the outlook of global growth and inflation. Consequently, the month of May saw the implicit measure of **financial market volatility** (VIX) rise to its highest level since January (20.6%). Still, after the Fed gave clearer signals about the possibility of trimming the interest rate by year-end, global stock markets recovered in June, which was additionally supported by low yields on bonds as an alternative form of investment. At end-Q2, VIX was 1.4 pp higher q-o-q, and equalled 15.1%, while the volatility of emerging countries' currencies, measured by EM–VXY, declined by 1.0 pp to 8.2%. In July, EM–VXY dropped by another 1.2 pp, while VIX rose 1.0 pp.

The exacerbated trade tensions between the USA and its main trade partners China and Mexico reflected on the yields of ten-year US Treasuries, which edged down 0.4 pp to 2.0% in Q2, their lowest level since November 2016. As of end-May, the spread between the yields on ten-year and three-month US Treasuries has been in the negative zone, thus sparking additional fears of recession. Yields on ten-year German government bonds, which are considered safe assets, went deeper into the negative territory in Q2 and reached their lowest level at end-June (-0.33%). Yields on the comparable French and Austrian bonds also entered the negative zone. Seeking to make profit, investors purchased bonds of peripheral countries in the euro area, which led to a decline in their yields, notably on ten-year government bonds of Greece (by 1.3 pp) and Portugal (by 0.8 pp). The yields continued to slide in July, reaching their historic lows in a number of euro area countries.

Observed at the end of the period, of the major global currencies the only one weakening to the **dollar** in Q2 was the British pound (-3.2%) due to the rising risk of a no-deal Brexit, which annulled the pound's appreciation from Q1. The Japanese yen and the Swiss franc, both considered safe currencies, gained on the dollar by 3.0% and 2.2% respectively, as did the Russian rouble (2.6%) and the euro (1.3%), whereby the euro regained some of the value it lost in Q1. The **euro gained on the dollar** in the wake of the Fed's June meeting which gave hints of the Fed's monetary policy accommodation. However, the dollar rose in July and at the end of the month reached its highest value against the euro in two years. This took place following a Fed meeting and the FOMC officials' statement that the decision on trimming the federal funds rate is not the beginning of a longer cycle of rate cuts.

Low and in some cases negative yields on bonds, as well as high prices of shares, coupled with the growing uncertainty in global financial markets, fuelled the demand for gold, as a safe asset, and in turn drove its price

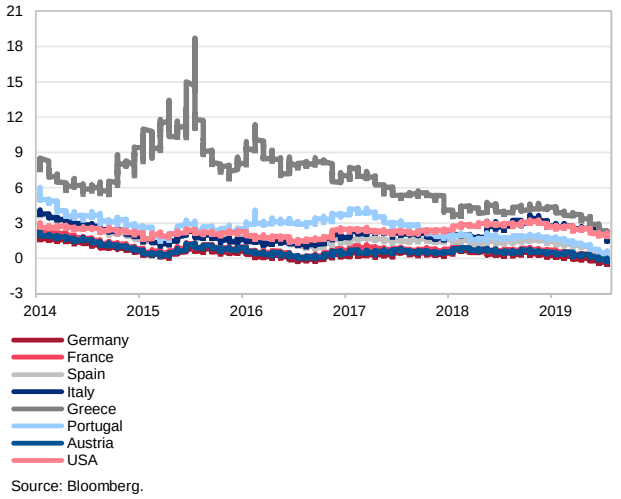
Chart IV.7.10 **Implied volatility of the global financial market***
(in %)



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.7.11 **Yields on ten-year bonds of selected countries**
(daily data, in %)

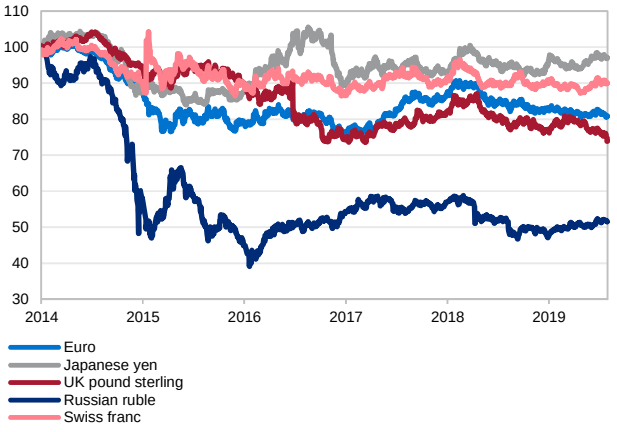


Source: Bloomberg.

Chart IV.7.12 **Difference between yields on 10y and 3m US treasuries**
(in %)

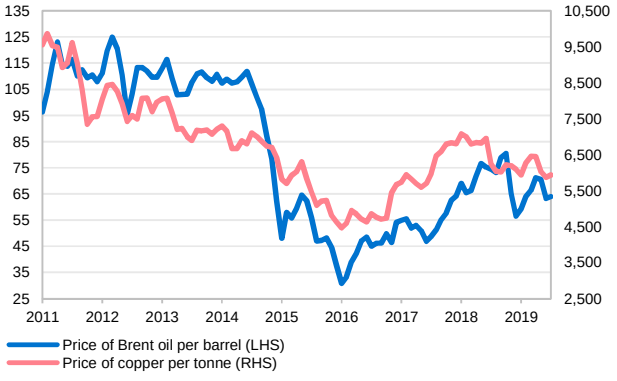
Source: Federal Reserve Bank of St. Louis.

Chart IV.7.13 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



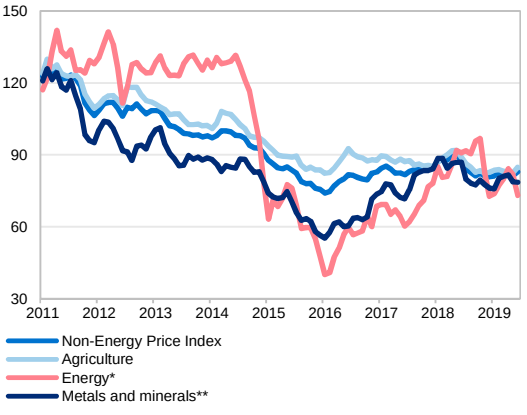
Source: IMF.
* Growth indicates appreciation.

Chart IV.7.14 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

Chart IV.7.15 **Primary Commodity Prices Index**
(2010 = 100)



Source: World Bank.
* Crude oil, natural gas and coal.
** Copper, aluminium, iron ore, lead, nickel, zinc, copper and tin.

up. An additional incentive to the growing price of gold came from the increased demand of central banks which are building up the share of gold in their FX reserves. In Q2, the **price of gold** rose by 8.8% and then by another 1.3% in July.

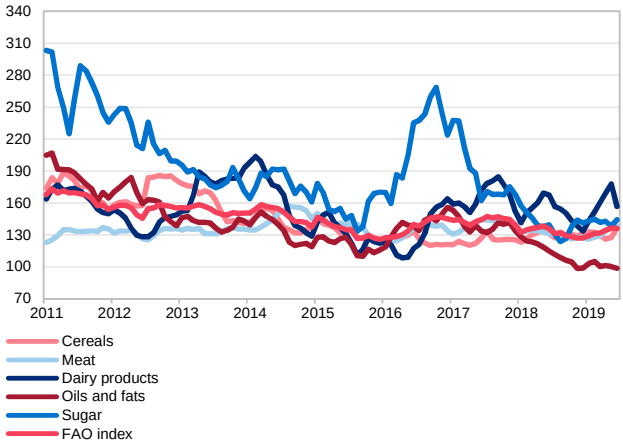
The global oil price continued up in the first half of Q2, largely due to concerns over the subdued oil supply in the global market. After reaching USD 74 per barrel in May, its highest level since October 2018, the price of oil fell by around 15% by mid-June due to concerns over the global economic outlook amid tensions in international trade. As of mid-June, the oil price resumed an upward trajectory, primarily owing to heightened geopolitical tensions between the USA and Iran which threaten to jeopardise major global oil supply chains. The oil price hike was backed by an agreement between the USA and China on resuming their talks, as well as dollar's weakening in light of hints at the Fed's monetary policy easing. And yet, at end-Q2, the price of oil was still 4.6% lower than at end-Q1, equalling USD 64 per barrel. In early July OPEC members and other oil exporters reached an agreement on keeping the cap on production for another nine months, hence the oil price continued up until mid-July, dropping thereafter due to poorer prospects regarding global demand and resulting in imperceptible changes in oil price that month.

A downturn in global production and apprehension over global growth against the backdrop of heightened trade tensions reflected on the prices of metals as well, driving them down. When the USA raised import tariffs in May from 10% to 25%, affecting the USD 200 bn worth of imports from China, the other country responded by raising tariffs on US imports worth USD 60 bn, which further fuelled the uncertainty surrounding the economic growth of China as the world's biggest consumer of metals and minerals. According to the World Bank's index of primary commodity prices, the **prices of metals and minerals** decreased 3.2% in Q2. Despite subdued supply from Chile, due to a strike in one of its largest mines, the price of copper declined reflecting a slump in demand. Only the price of the iron ore continued to post robust growth due to US sanctions on imports from Iran, the closure of several mines in Brazil and the lower supply from Australia.

Measured by the FAO index, **world food prices** continued up, ending the quarter 3.2% higher than at end-Q1. The price of meat rose the most (7.0%), mainly as a result of higher import demand in East Asia, aimed to offset the reduction in pork production at home, caused by

a disease outbreak. The price of cereals increased by 5.2%, driven by corn prices that rose in anticipation of lower export inventories in the USA, the world's largest corn producer and exporter. Sugar prices also went up (1.6%), mainly due to decreased supply from Brazil and the EU. In contrast, of all food products in the FAO index, the prices of dairy and vegetable oil declined. After rising for five months, the prices of dairy decreased in June and were 2.5% lower than at end-Q1 owing to stepped-up global supply and weaker demand. The price of vegetable oil was at its lowest since last December (down by 1.7% in Q2), driven by the lower prices of palm and soybean oil.

Chart IV.7.16 **World Food Price Index**
(in real terms, 2002−2004 = 100)



Source: UN FAO.

V Inflation projection

Under the August central projection, we expect y-o-y inflation to continue to move within the target tolerance band – most likely in its lower part – until the end of the projection horizon. Inflation is projected at a low level owing to the still low cost-push pressures and aggregate demand rising on sustainable grounds. Compared to the previous projection, until the end of this year we expect a lower positive contribution of the group of fruit and vegetable prices and a negative contribution of petroleum products. Uncertainties surrounding the inflation projection are associated primarily with developments in the international commodity and financial markets and, to an extent, to administered price growth. On the whole, risks to the projection are judged to be symmetric.

We kept the GDP growth forecast for 2019 at 3.5%. As in the previous projection, GDP growth is expected to be fully led by domestic demand, whose positive contribution increased as a result of favourable investment and final consumption trends since the start of the year. On the other hand, due to softer external demand, the contribution of net exports is negative. In the medium run, we expect GDP growth to accelerate to around 4%, driven by investment, exports and viable growth in household consumption. Medium-term risks to the GDP projection are judged to be symmetric, while in the short term, i.e. during 2019, those stemming from the international environment are judged to be tilted to the downside and those from the domestic environment to the upside.

The medium-term inflation projection aims to show expected inflation movements (CPI) in the coming period, the main factors behind such movements and the underlying risks. The projection is set out in the form a range and the central projection. 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.

Projection assumptions

External assumptions

Over the past months, the international market faced increasingly clear signals hinting at monetary policy accommodation, followed by actual measures by leading central banks. This was fuelled by concerns that uncertainties surrounding trade policies of major world economies could adversely affect investment activity and, by extension, global growth. As trade and industrial production slackened at the global level, the projections of all relevant institutions envisage a slowdown in the global economy this year. However, under the assumption that trade tensions will not escalate further, gradual recovery is likely to ensue owing to the pick-up in global investment activity which should be spurred by better financial conditions thanks to Fed's and ECB's monetary policy accommodation. China's domestic demand is also projected to grow, under the impact of

Table V.0.1 **Major projection assumptions**

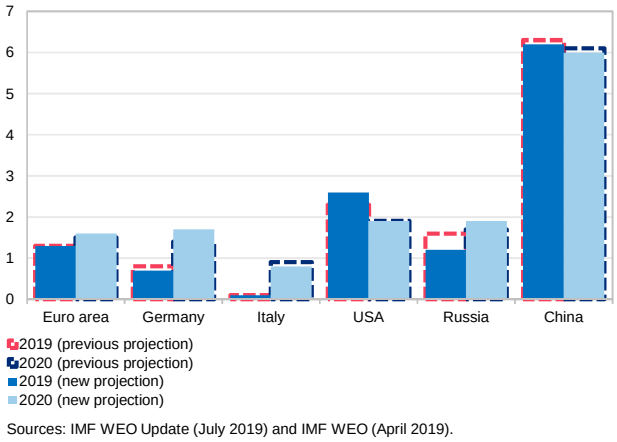
	2019		2020		2021	
External assumptions	May	Aug.	May	Aug.	May	Aug.
Euro area GDP growth	1.1%	1.2%	1.6%	1.4%	1.5%	1.4%
Euro area inflation (annual average)	1.2%	1.3%	1.5%	1.4%	1.6%	1.6%
ECB key policy rate (average)*	0.0%	0.0%	0.1%	0.0%	0.4%	0.1%
International prices of primary agricult. commodities (Q4 to Q4)**	-5.8%	-3.0%	2.9%	3.1%	2.5%	2.5%
Brent oil price per barrel (December, USD)	70	63	66	60	63	59
Internal assumptions						
Administered prices (Dec. to Dec.)	3.8%	3.7%	4.0%	4.0%	4.0%	4.0%
Trends						
Appreciation trend of the real exchange rate (average)	0.3%	0.3%	0.4%	0.4%	0.5%	0.5%
Real interest rate trend (average)	0.4%	0.2%	0.2%	0.0%	0.1%	0.0%

* ECB Survey of Professional Forecasters.

** Composite index of soybean, wheat and corn prices.

Sources: NBS, ECB, Euronext, CBOT and Bloomberg.

Chart V.0.1 **IMF's revised forecast for real GDP growth for 2019 and 2020**
(in %)



Sources: IMF WEO Update (July 2019) and IMF WEO (April 2019).

recent measures. According to the IMF's July projection,[29] global growth will decelerate from last year's 3.6% to 3.2% this year, only to accelerate to 3.5% in 2020. For both years, this is a 0.1 pp lower projection relative to April. As indicated by the IMF, global trends since the start of the year signal weaker than expected activity – investment and consumer demand for durable goods are weak both in advanced and emerging economies, as enterprises and households still refrain from consumption. For the projected growth acceleration to materialise in 2020, the disagreements over trade relations among leading world economies should be resolved.

The **economic growth of the euro area**, our most important trade partner, was adjusted in our current projection in accordance with the ECB's June projection. Under that projection, real GDP growth of the euro area will slow from 1.8% in 2018 to 1.2% in 2019, only to step up to 1.4% in 2020 and 2021. Compared to the previous projection, growth for this year was adjusted upward by 0.1 pp, on account of more vigorous than expected growth in Q1. As the carry-over effect will be weaker in 2020, the projection of euro area growth for that year was cut by 0.2 pp to 1.4%. On the whole, the ECB expects the euro area growth to be supported by domestic factors, most notably a highly accommodative monetary policy, a further rise in employment and wages and fiscal easing. Furthermore, the ECB expects that gradual recovery of external demand will lend a stronger impulse to growth until the end of the projection horizon. Consensus Forecast expects somewhat softer euro area growth compared to the ECB. In July, just like three months ago, it forecast a growth slowdown to 1.1% in 2019. Consensus Forecast again revised down the euro area growth for 2020 by 0.1 pp to 1.2%. The IMF is somewhat more optimistic and has not changed its euro area growth projection (1.3%), while raising its projection for next year by 0.1 pp to 1.6%.

When it comes to **our most important trade partners in the euro area**, compared to its forecast three months ago, Consensus Forecast again reduced the expected growth of **Germany** for this and next year, by 0.1 pp each, to 0.7% and 1.4%. Namely, despite substantial and broad-based exports, the German economy suffers from the trade conflict between the USA and China, as well as Brexit. The automobile industry has still not fully recovered from the regulatory measures from September 2018, which, together with falling external demand, brought about a 12% y-o-y fall in production in H1 2019.

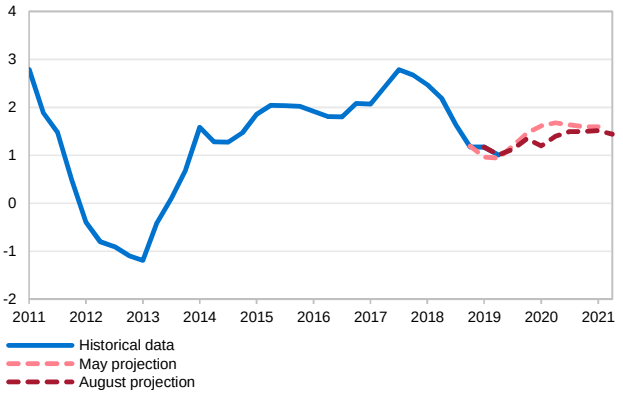
[29] World Economic Outlook, July 2019.

However, the situation in the labour market is assessed to remain positive, which should continue to spur domestic consumption and economic growth. The projection of **Italy's** economic growth in 2019 is unchanged from three months ago (0.0%) and reflects the opinions of Consensus Forecast's respondents that the Italian economy will, after all, not recover in the remainder of the year. It was cut by 0.1 pp to 0.4% for 2020.

Unlike euro area countries, the **growth prospects of countries in the region**, which are also our important trade partners, are more favourable than three months ago although growth in this and next year is expected to be lower than in 2018. According to Consensus Forecast, most countries in the region will continue to rely on domestic demand to compensate for softer external demand, while the signalled accommodation of the ECB's and Fed's monetary policies will extend the favourable external conditions of financing. In the medium run, optimism is, after all, overshadowed by concerns over euro area growth and potential further escalation of protectionism. The expected growth in the region of **Southeast Europe**[30] picked up to 3.5% and 2.9% for 2019 and 2020, up by 0.4 pp and 0.1 pp from April. The growth estimate for **Central Europe**[31] of 3.8% for this year was also revised upward, by 0.3 pp relative from April, while remaining unchanged for next year (3.1%). Observed by countries of these two regions, the GDP growth projections for Hungary, Romania, Poland and Croatia increased the most, while those for the Czech Republic, Slovakia and Albania declined.

Inflationary pressures remain low in **most advanced economies** and projected inflation continues to move below the central bank targets throughout the projection horizon. Our projection operates under the assumption that **euro area inflation** will move in line with the ECB's June projection, according to which it will be moderate this year, only to gradually rise until the end of the projection horizon, to 1.6% in 2021. Compared to the previous projection, the ECB forecasts slightly higher inflation this year due to rising oil prices, and moderately lower inflation in 2020 over the assumptions of somewhat steeper falls in oil prices.[32] Professional forecasters[33] also anticipate lower inflation in the euro area in the coming period. According to the ECB's July

Chart V.0.2 **Assumption for euro area GDP growth**
(y-o-y growth, in %)



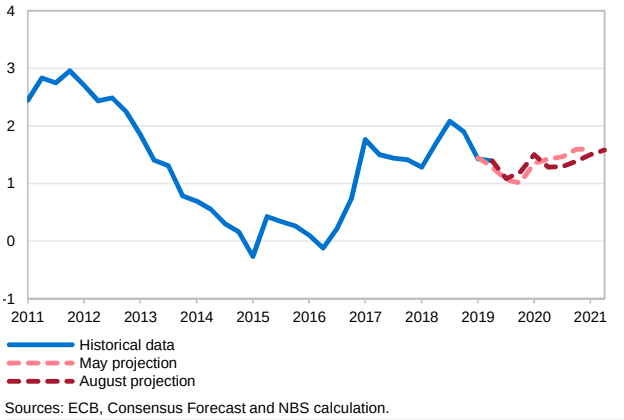
Sources: ECB, Consensus Forecast and NBS calculation.

Table V.0.2 **Economic growth estimate by country**
(in %)

	April 2019		July 2019	
	2019	2020	2019	2020
Poland	3.9	3.3	4.3	3.4
Czech Republic	2.6	2.5	2.5	2.4
Hungary	3.6	2.8	4.2	3.0
Albania	3.7	3.4	3.6	3.3
Bulgaria	3.3	3.0	3.3	3.0
Bosnia and Herzegovina	2.9	2.9	3.1	3.1
North Macedonia	2.9	3.0	3.0	3.1
Romania	3.1	2.7	3.8	2.9
Slovakia	3.6	3.2	3.5	3.1
Slovenia	3.2	2.8	3.3	2.8
Croatia	2.5	2.5	3.0	2.5

Source: Consensus Forecast.

Chart V.0.3 **Assumption for euro area inflation**
(y-o-y growth, in %)



Sources: ECB, Consensus Forecast and NBS calculation.

[30] Albania, Bosnia and Herzegovina, Bulgaria, Croatia, North Macedonia, Romania and Serbia.

[31] The Czech Republic, Hungary, Poland, Slovakia and Slovenia.

[32] The ECB's June projection was concluded on 15 May when global oil prices exceeded USD 70 per barrel.

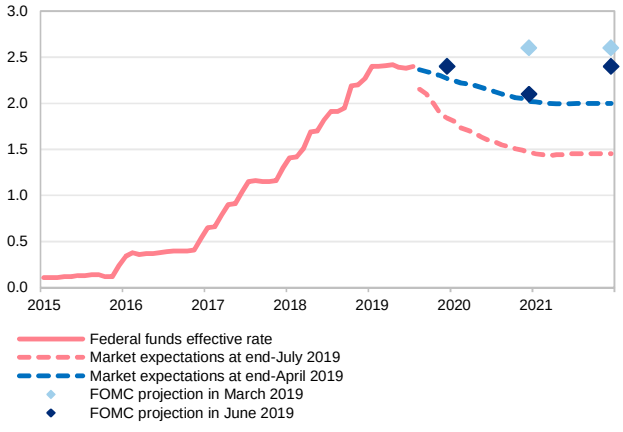
[33] ECB Survey of Professional Forecasters (SPF).

Table V.0.3 **Consumer prices estimate by country**
(annual average, in %)

	April 2019		July 2019	
	2019	2020	2019	2020
Poland	1.8	2.5	2.1	2.7
Czech Republic	2.4	2.0	2.6	2.1
Hungary	3.1	3.0	3.4	3.2
Albania	2.2	2.4	1.9	2.1
Bulgaria	2.8	2.6	3.0	2.7
Bosnia and Herzegovina	1.7	1.7	1.5	1.7
North Macedonia	1.8	2.1	1.8	2.1
Romania	3.5	3.0	3.9	3.2
Slovakia	2.4	2.3	2.5	2.3
Slovenia	1.6	1.8	1.6	1.7
Croatia	1.2	1.7	1.0	1.6

Source: Consensus Forecast.

Chart V.0.4 **Expected Fed funds rate***
(p.a, in %)



Sources: Fed and Bloomberg.
* Futures-based market expectations.

survey, professional forecasters lowered their expectations again and, relative to April, they anticipate inflation to be 0.1 pp lower in both this and in the following two years – measuring 1.3%, 1.4% and 1.5% respectively. In addition to data on lower than expected inflation in the period from the previous survey, this was induced by weaker prospects for euro area growth. The Consensus Forecast kept its expected inflation unchanged at 1.3% and 1.4% for 2019 and 2020.

Major inflationary pressures are not expected in the countries of the region either. Inflation in these countries should be determined mainly by economic growth and rising wages on the one hand, and low imported inflation on the other, though the risk of slightly higher inflationary pressures will persist if the rise in global oil prices exceeds expectations. The Consensus Forecast raised its 2019 inflation forecast for the **Southeast European region** by 0.2 pp from April to 3.0% in July. Its projected inflation rate for 2020 was raised by 0.1 pp to 2.7%. As regards inflation in **Central Europe**, the Consensus Forecast projection for 2019 and 2020 was raised by 0.3 pp and 0.2 pp from April, to 2.4% and 2.6%.

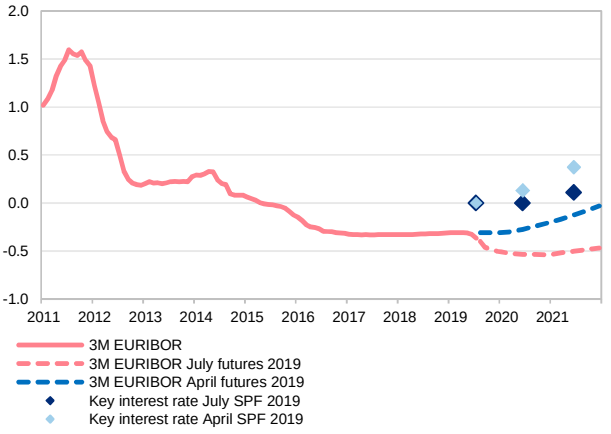
In the context of the global slowdown, the paths of **key rates of leading central banks** were revised significantly down. In July, the Fed narrowed its target federal funds range by 25 bp (to 2.00–2.25%), due to the negative effect of global developments on the US economic prospects and subdued inflationary pressures. However, the question remains as to whether these measures signal the start of a new cycle of monetary policy easing, i.e. whether cuts to the key interest rate will continue in the period to come, or this is a one-time adjustment. Judging by futures, the market expects the cuts to continue – the probability for this to take place in September, by additional 25 bp, equals around 62%. When it comes to **financial conditions in the euro area**, which is also Serbia's most important financial partner, our projection assumption reflects the ECB's announcements that conditions will be more favourable than we assumed in the previous projection. In addition to the announcement that the key interest rates will remain at the current level at least through mid-2020, in July the ECB hinted that they may be even lower than the current level. It also underscored that it will reinvest the principal payments from maturing securities purchased under the asset purchase programme for an extended

period of time past the date when it starts raising its key interest rates. In accordance with earlier announcements, the ECB will implement the new series of quarterly targeted longer-term refinancing operations (TLTRO-III) from September to March 2021, to maintain banks' favourable liquidity conditions. The ECB also clearly signalled that it was ready to do even more to ensure the continued sustained convergence of inflation to the target in the medium term, while at the same time expecting more from fiscal policy. Professional forecasters also expect the ECB's monetary policy normalisation to unfold at a slower pace than three months ago. In July, they stated that the ECB's key interest rate will not increase until 2021 (and not in 2020 as in the previous survey) – after touching zero this and next year, it will average 0.11% in 2021. The slower pace of normalisation of the ECB's monetary policy is also suggested by end-July futures, according to which three-month EURIBOR should move deeper in the negative zone until the end of the projection horizon. Our projection assumption is that the EUR/USD exchange rate will remain unchanged throughout the projection horizon, lingering at the average level in the last two weeks before the projection was finalised (EUR/USD 1.11). The expected new cycle of monetary policy accommodation of leading central banks, along with the abatement of trade tensions, should positively affect conditions in the international financial market, capital flows to emerging economies and the stability of their FX markets.

Uncertainty in terms of future trends in the international environment relates to movements in **global primary commodity prices.** This mostly concerns the global **oil price**, which reached USD 74 per barrel in May, but declined thereafter, touching USD 64 per barrel in July. The recent price plunge reflects the growing uncertainty over global oil demand due to poor global economic indicators. The weakening of oil demand, along with the vigorously rising US supply, helped increase global inventories in the year so far and limit the impact of factors exerting pressure towards rising oil prices, notably dented supply from Venezuela and Iran and the agreement between OPEC members and other oil exporting countries about the continued cap on production until the end of Q1 2020.

According to EIA's[34] estimate, the global Brent oil price should be relatively stable until the end of this and next year. Elevated oil production in the USA and other

Chart V.0.5 **Expected ECB interest rate* and 3M EURIBOR futures**
(p.a., in %)



Sources: ECB and Bloomberg.
* ECB Survey of Professional Forecasters (SPF).

Chart V.0.6 **Assumption for Brent oil prices**
(USD/barrel)

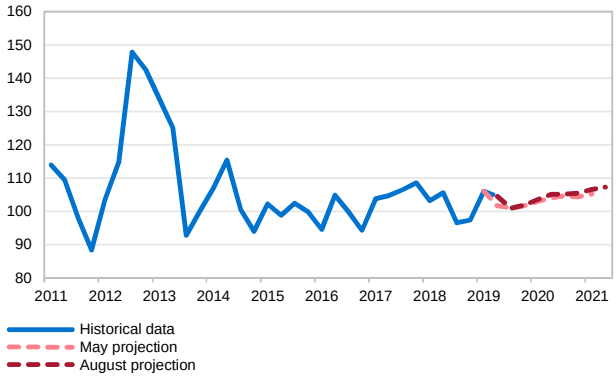
Source: Bloomberg.

[34] U.S. Energy Information Administration.

Chart V.0.7 **Assumption for international prices of primary agricultural commodities**
(Q4 2013 = 100)

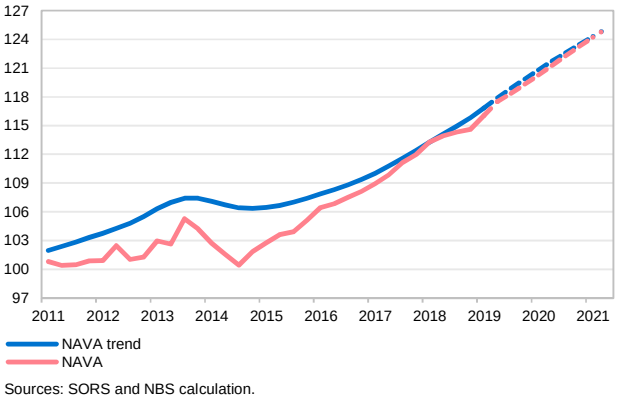
Sources: CBOT, Euronext and NBS calculation.

Chart V.0.8 **Assumption for domestic prices of primary agricultural commodities***
(base index, 2013 = 100)



Sources: Commodity Exchange Novi Sad, CBOT, Euronext and NBS calculation.
* Measured by the composite index of the prices of wheat, corn and soybean.

Chart V.0.9 **Output gap projection**
(Q3 2008 = 100)



Sources: SORS and NBS calculation.

countries that are not OPEC members, along with the slowdown in global oil demand, should contribute to rising inventories in 2020, while the effects of the IMO 2020 regulation could act in the opposite direction, so eventually the oil price would remain unchanged in 2020. Consistent with early-August oil futures (taking into account the average of the last two weeks), the new projection assumes the global oil price of USD 63 per barrel in December 2019, and USD 60 and USD 59 per barrel in December 2020 and 2021, which is somewhat lower than our projection three months ago.

There is also uncertainty over movements in the global prices of other primary commodities, **notably metals and primary agricultural commodities**. The volatility of these prices reflects the growing influence of supply-side factors, as opposed to subdued global demand. Our projection operates on futures data from Euronext Paris and the Chicago Board of Trade. According to these data, we assumed a 3.0% fall in the prices of primary agricultural commodities in 2019, and their subsequent growth of 3.1% and 2.5% in 2020 and 2021, respectively.

Internal assumptions

Primary agricultural commodity prices in the domestic market,[35] as well as at the global level, were on the rise from April, most notably wheat prices. Still, wheat prices in the domestic market plummeted in July, with the arrival of this year's yields. Looking at the dynamics of primary agricultural commodity prices, the costs of raw materials in food production were somewhat above the neutral level in H1 2019. Thereafter, as wheat prices dropped in July, food production costs declined and should return to the neutral level in Q3. Bearing in mind the movements of futures on the Paris and Chicago stock markets, we expect domestic prices of agricultural products in 2019 to be somewhat lower than last year (by 3.5%). In the coming period as well, prices in the domestic market are likely to mirror the dynamics of their global counterparts, given their mutual dependence, therefore they are expected to rise moderately over the following two years (3.5% and 2.5%, respectively).

Further growth in **aggregate demand** is a projection assumption. In Q2, NAVA rose faster than its potential, hence the negative output gap narrowed. In the coming period, we expect further growth in capacity utilisation, i.e. the narrowing of the negative output gap, which began in 2014. Domestic demand will be supported by a further

[35] Measured by the composite index of the prices of wheat, corn and soybean.

rise in private sector wages and employment, increased public sector wages and pensions, past monetary policy easing by the NBS and the still relatively low interest rates in the euro area.

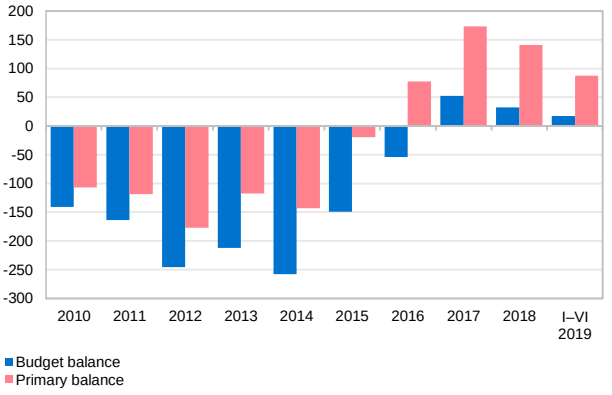
As for **administered prices**, the anticipated adjustment to the prices of electricity and natural gas did not take place last year, therefore the increase in this group of prices was halted at 2.4%. Since the start of the year, there have been no major changes in these prices, except for the February increase in cigarette prices in the wake of an excise tax rise, resulting in administered prices rising 2.3% y-o-y in June. Given the July cigarette price hike, with the assumption that the prices of natural gas and electricity will be adjusted this year, we expect administered price growth at 3.7% y-o-y in December, and at around 4% in 2020 and 2021.

Sustained **positive fiscal trends** contributed to overall macroeconomic stability and the country's development prospects. Consolidated budget has been in the surplus since the start of the year (RSD 17.3 bn in H1 or 0.7% of GDP), and the share of public debt in GDP declined to 51.4% in June. According to the estimate of the Ministry of Finance, the fiscal policy stance is likely to be slightly expansionary in the coming period, without major pressures on inflation growth. Growth in the government's capital expenditures will contribute to the investment increase, while rising public sector wages and pensions will be conducive to sustainable consumption growth. This year's deficit is projected at 0.5% of GDP, i.e. the medium-term deficit target, which will ensure that the downward trajectory of public debt is maintained.

The balanced public finances and the firm downward trajectory of public debt, along with sustainable economic growth and low inflation, all form a basis for the improvement of macroeconomic prospects and a decline in the country risk premium. The continued decline of public debt in the coming period should reflect positively on **credit rating**, which will remain conducive to further **relative stability in the FX market and Serbia's increased resilience to risks from the international environment**.

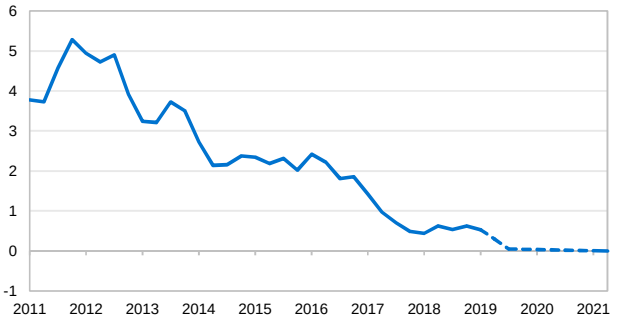
As in previous projections, we expect **inflation expectations** to remain anchored around the central midpoint until the end of the projection horizon. In view of this, as well as the country's lower risk premium, we expect the **real interest rate to continue trending down** throughout the projection horizon.

Chart V.0.10 **General government fiscal and primary budget balance**
(in RSD bn)



Source: Ministry of Finance.

Chart V.0.11 **Real interest rate trend**
(in %)



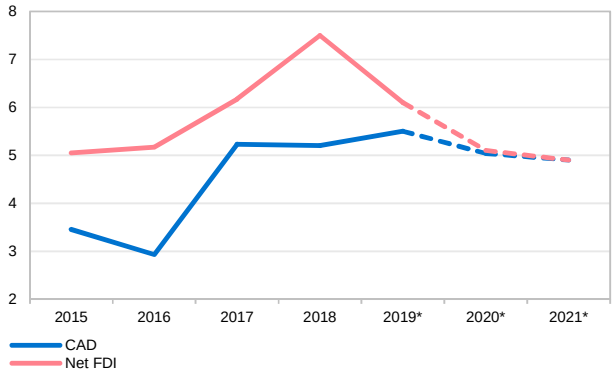
Sources: CBOT, Euronext and NBS calculation.

Table V.0.4. **Estimate of fiscal trends in 2019−2022**
(in % of GDP)

	Estimate	Projection		
	2019	2020	2021	2022
Public revenues	40.8	39.9	39.4	39.0
Tax revenues	36.0	35.6	35.4	35.2
Non-tax revenues	4.5	4.0	3.7	3.5
Public expenditures	41.3	40.4	39.9	39.5
Expenditures for employees	9.4	9.4	9.4	9.4
Pensions	10.4	10.2	10.0	9.8
Interests	2.1	1.9	1.8	1.7
Capital expenditures	4.2	4.3	4.5	4.6
Total balance	-0.5	-0.5	-0.5	-0.5
Primary balance	1.6	1.4	1.3	1.2

Source: Ministry of Finance.

Chart V.0.12 **Current account deficit and net FDI inflow**
(in % of GDP)



Source: NBS.
* NBS projection.

Export is expected to maintain a high growth rate in 2019 as well, driven by past investment and growth, albeit slower, of external demand. The import of equipment and intermediate goods is also expected to rise owing to the continuation of the investment cycle, while the higher standard of living of citizens and consumer demand will contribute to the rising import of consumer goods. We estimate that the share of the current account deficit in GDP will be around last year's level. In the medium run, we expect further narrowing in the current account deficit given the expected stronger impact of FDI on rising exports in the years to come. At the same time, we estimate that the FDI inflow going forward will be high and, as so far, more than sufficient to cover the current account deficit.

Projection

Inflation projection

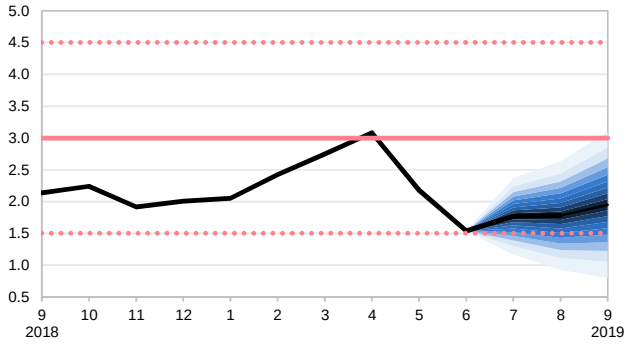
Under our current projection as well, y-o-y inflation is expected to remain low and stable in the next two years. It will continue to move within the target tolerance band until the end of the projection horizon – most probably in the lower part of the target band. Compared to the previous projection, the new medium-term projection is lower until the end of this year, and then somewhat higher until the end of the projection horizon. The main reason for lower projected inflation through 2019 is the smaller than expected rise in vegetable prices in May and June. This pushed down the projected y-o-y inflation rates until the end of this year, but, due to the base effect, drove them up next year.

Short-term inflation projection

Under the central projection for Q3, y-o-y inflation is expected to increase slightly over the next months and reach around 2% in September.

Such movements in y-o-y inflation will be prompted by the expected stronger contribution of food prices on the back of rising prices of primary agricultural commodities and world meat prices in the past several months, as well as a rising contribution of industrial products excluding food and energy due to the continued gradual rise in aggregate demand. Working in the opposite direction will probably be the reduced contributions of the prices of petroleum products and services. Core inflation is expected to remain low and stable, moving slightly above the current level.

Chart V.0.13 **Short-term inflation projection**
(y-o-y rates, in %)



Source: NBS.

The risks to the short-term inflation projection concern primarily the movement of unprocessed food prices, and the movement of global oil and primary commodity prices.

Medium-term inflation projection

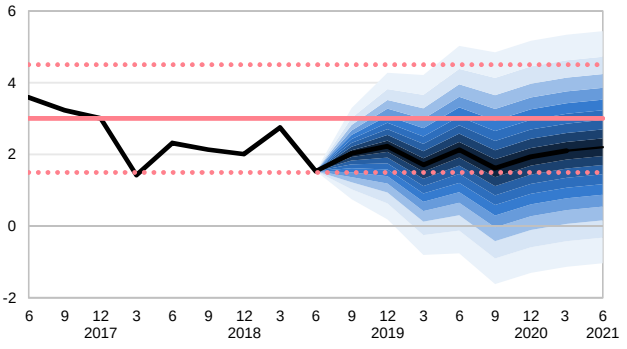
Based on projection assumptions, we expect y-o-y inflation to move within the target tolerance band in the next two years, most probably in the lower part of the target band. It will continue to reflect the still low cost-push pressures and viable growth in aggregate demand.

As in the previous projection, the rise in **aggregate demand**, almost uninterrupted since late 2014, is likely to persist, i.e. disinflationary pressures from the negative output gap will weaken. The tendency of a further gradual reduction in the output gap and its entering the positive zone in 2021 are expected largely on the back of the contribution of domestic demand. It will still be supported by positive trends in the labour market, and rising public sector wages and pensions, through a positive impact on the disposable income of households. A positive impetus to disposable income is also coming from lower interest rates and subsequently lower loan repayment costs, achieved owing to past NBS monetary policy easing. A positive effect is also provided by low rates on euro-indexed loans, which should remain low longer than initially expected, given the announced slower normalisation of ECB's monetary policy. Low interest rates will also be supported by the country risk premium which recently fell to its historical low. On the other hand, the slowdown in the global economy and growth in the euro area, notably Germany and Italy, our main trade partners, as well as the capping of steel exports to the EU, will bring about weaker external demand.

As in the previous projections, **administered price** growth is likely to be 3.7% this year, reflecting mainly the cigarette price adjustment and the potential rise in natural gas and electricity prices, which was absent last year. The contribution of administered price growth to inflation would thus be higher by 0.3 pp than last year. Similarly to the previous projection, administered price growth is expected at around 4% both in 2020 and 2021.

After rising since the start of the year, **global oil prices** declined from the previous medium-term projection, impacting on a reduction in petroleum product prices in the domestic market in June and the shift of their contribution to y-o-y inflation to the negative zone. According to futures, market participants do not expect

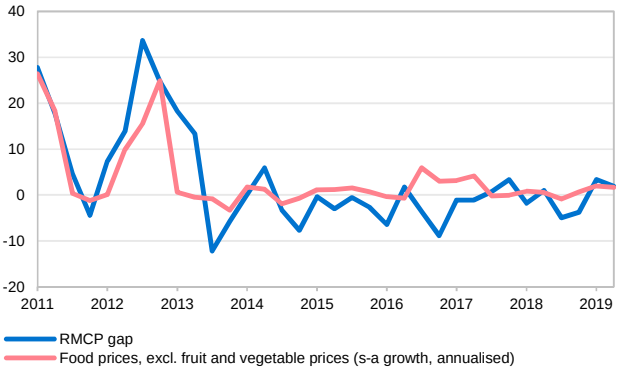
Chart V.0.14 **Inflation projection**
(y-o-y, in %)



Source: NBS.

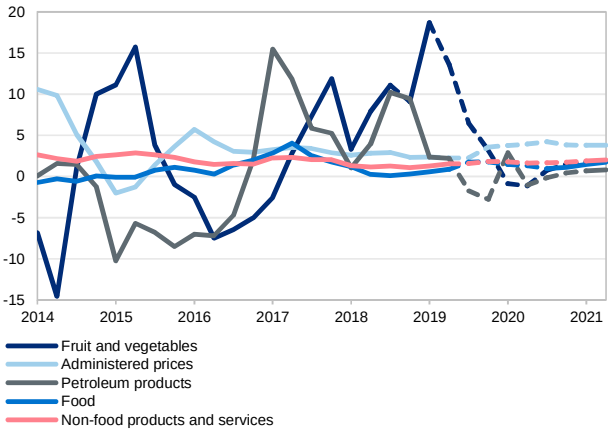
The fan chart depicts probability of various inflation outcomes in the next eight quarters. Central projection is within the darkest central band and the probability that inflation would lie in it is 10%. Each following shade includes 10% probability, which means that outturns of inflation somewhere 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%.

Chart V.0.15 **RMCP and food prices**
(in %)



Sources: Commodity Exchange Novi Sad, SORS and NBS calculation.

Chart V.0.16 **Projection of inflation components**
(average y-o-y rate, in %)



Source: NBS.

significant changes in global oil prices relative to the current level, so the contribution of petroleum product prices could remain negative until the end of the current year. Thereafter, the contribution of petroleum product prices should stabilise at a low positive level.

With the onset of this year's agricultural season, **fresh vegetable prices** reduced their contribution to inflation growth (from 1.6 pp in March and April to 0.35 pp in June), to a greater extent than we expected in earlier projections. This will bring about lower projected inflation until the end of this year, while the base effect on these grounds will work in the opposite direction next year.

Looking at the dynamics of primary agricultural commodity prices, we estimate that the **costs of raw materials in food production** will move slightly below the neutral level. Thereafter, we expect a moderate rise in primary agricultural commodity prices and the return of costs of raw materials in food production to the neutral level, in accordance with the assumed movement in global primary agricultural commodity prices given that global prices have the major impact on their domestic counterparts.

Given the expected movement in prices of primary agricultural commodities, which are important raw materials in processed food production (wheat, corn, soybean), we expect no upward pressures on **food inflation** on these grounds. We believe its short-term movement will be determined primarily by the expected pork price hike, which mirrors global rises in the past months. In the medium run, we expect its growth to be modest and led primarily by the gradual rise in aggregate demand.

A similar trend is expected for **non-food inflation** – its moderate rise will be determined by rising aggregate demand. We expect both food and non-food inflation to continue to move below 3.0% over the projection horizon.

We also do not expect pressures from rising dinar-denominated **import prices** until the end of the projection horizon, in light of expected continued low inflation in the international environment (notably in the euro area).

Uncertainties surrounding the inflation projection are associated primarily with movements in international commodity and financial markets, and administered price growth to an extent.

The prices of primary commodities in the **international commodity market** could be both lower and higher than assumed in the coming period, owing both to demand- and supply-side factors. In terms of demand-side factors, there are risks that the global economic slack could be stronger than estimated, which would diminish demand for primary commodities. Trade tensions between the leading world economies are still present, as well as geopolitical tensions, which may undermine business confidence and reflect negatively on investment, productivity and economic growth, prompting a decline in demand for primary commodities, notably oil. The greater than expected slowdown of China's growth would reflect particularly on falling demand for primary commodities, given that the Chinese economy has become the main driver of demand for global primary commodities. Although China responded to the slowdown with monetary and fiscal stimuli, economic activity could be lower than expected, particularly in the case of renewed escalation of trade tensions.

Supply-side factors are specific for each primary commodity. Although market participants, according to futures, do not expect any significant changes in **global oil prices** relative to the current level, they are possible in both directions given the unstable balance of global supply and demand. Geopolitical tensions are not waning, primarily due to the US sanctions on oil exports from Iran and Venezuela, as well as developments in Libya. The duration of the current cap on OPEC's oil production is uncertain, as well as the degree to which the member countries will adhere to it. It is also uncertain how the oil processing and transportation industry will respond to the introduction of the new standards by the International Maritime Organization as of early 2020, and what the effect on global oil prices will be, although no significant movements are expected in the market. On the other hand, oil production in the US is dynamic and its growth, as well as a potentially higher rise in production of OPEC members, could additionally reduce global oil prices. Global oil prices will also reflect on the prices of **primary agricultural commodities**, notably cereals, not only through the costs of fuel in agricultural production and fertilisers prices, but also through the impact on biofuel production. However, in the past several years the prices of global primary commodity prices increased slightly, or even declined, although futures envisaged growth. Given the uncertainty as to the movement in global oil prices and primary agricultural commodities, the risks to the projection based on global primary commodity prices are assessed to be symmetric.

The risks to the projection are also associated with developments in the **international financial market,** notably the monetary policy stance of the ECB and Fed, and consequently conditions in the international financial market and the EUR/USD exchange rate. In late July, the Fed cut its key rate, for the first time since the economic crisis of 2008, and made the decision to halt balance sheet reductions in August (two months earlier than planned). However, it is uncertain whether these measures of the Fed signify the start of a new monetary accommodation cycle, i.e. whether the key rate cuts will continue in the coming period, or this is a one-time adjustment. The ECB signalled that the normalisation of its monetary policy will be slower than expected and that it will start to implement the new, third series of targeted longer-term refinancing operations (TLTRO-III) in September, to preserve favourable borrowing conditions for banks. The uncertainty as to monetary policies of leading central banks could bring about the instability of global capital flows. Moreover, further rise in protectionism in international trade could deepen the instability in the international financial market, and thus the uncertainty as to capital flows.

The projection operates on the assumption of **administered price** growth of 3.7% this year, after the last year's relatively modest growth of 2.4%. The assumed administered price growth for 2020 and 2021 is around 4.0%. Given the modest administered price growth in the past three years, we consider the risks to the projection to be mildly tilted to the downside.

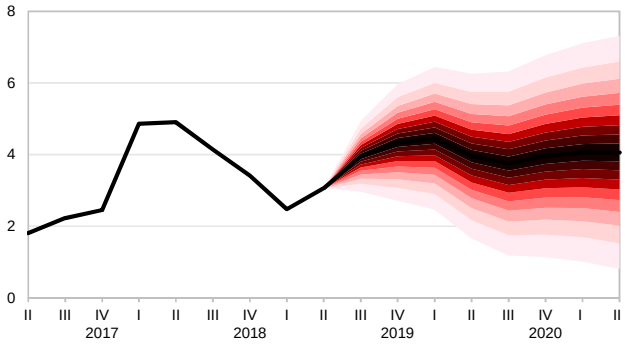
Overall, the **risks to the inflation projection are judged to be symmetric until the end of the projection horizon**.

Monetary policy decisions in the coming period will continue to depend on the assessment of the impact of past monetary policy easing and other domestic and external factors on inflation in Serbia. Given that the key risks to the projection emanate from the international environment, the NBS will continue to carefully monitor and analyse trends in the international commodity and financial markets, and assess their impact on domestic economic developments. As so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium run, which will, along with the preservation of financial stability, contribute to sustainable economic growth and preservation of macroeconomic stability.

GDP projection

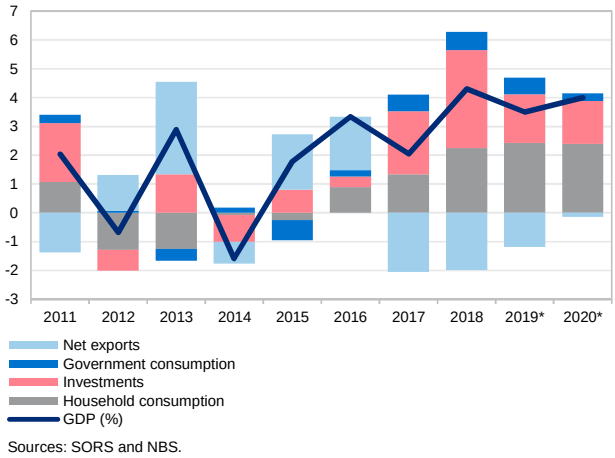
We kept the GDP growth projection for 2019 at 3.5%. Within domestic demand, we expect faster fixed investment growth compared to the previous estimate, as a result of a continued high FDI inflow and intensive investment in transportation and energy infrastructure. In addition, sustainable growth in the main sources of consumption, notably private sector wages and employment, public sector wages and pensions, and movements in consumption indicators in the year so far, suggest that household consumption will rise faster than initially expected. On the other hand, given the further slowdown in external demand, we estimate that the contribution of net exports will be negative, though to a lesser extent than in 2018. At the same time, we expect the exports of goods and services to continue to record vibrant growth, propped by the activation of new and expansion of the existing export capacities, and high export inventories of agricultural commodities. The imports of goods and services should also continue to grow, reflecting the industry's higher needs for equipment and intermediate goods, on account of continued robust investment cycle and increasing inclusion of domestic companies in global value chains. The growth in imports is also likely to be aided by increasing imports of consumer goods, as a result of elevated consumer demand.

Chart V.0.17 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

Chart V.0.18 **Contributions to real GDP growth**
(in pp)



Sources: SORS and NBS.
* NBS estimate.

The recovery of domestic demand and the improvement of the standard of living should encourage continued growth in service sectors, which should, taken together, contribute the most to GDP growth in 2019 on the production side. A positive contribution is also expected from further growth in the construction sector, as indicated, in addition to the movements in the year so far, by the continued intensive investment in transportation and energy infrastructure, and in the real estate market as well. In addition, an impetus is also likely to come from industrial production, which is expected to recover in the remainder of the year, on account of the continued vigorous FDI inflow and the completion of overhauls in the oil and chemical industries. On the other hand, we estimate that agricultural production, due to the base effect, will probably decline and give a negative contribution to GDP.

Real GDP growth is expected at around 4% in the medium run. The preservation of macroeconomic stability, favourable financial conditions, continued implementation of structural reforms, further EU integration and continued implementation of infrastructure projects should contribute to a further rise

in fixed investment. A positive impetus to GDP growth is also likely to come from household consumption, consistent with the continued positive tendencies in the labour market and the recovery of consumer confidence. Investment, particularly in tradeable sectors, should ensure the preservation of a relatively strong pace of growth of goods and services exports, also reflecting the expected gradual recovery of external demand. On the other hand, the continuation of the investment cycle will impact the rising imports of equipment and intermediate goods, while a further rise in final consumption will push up the imports of consumer goods, which is why the contribution of net exports to GDP in the medium term will most probably be neutral.

On the production side, the strongest contribution to gradual acceleration of GDP growth in the medium run is likely to come from faster growth in manufacturing, resulting from the activation of new and expansion of the existing capacities on the supply side, and from gradual growth acceleration in main foreign trade partners on the demand side. Acceleration is also expected in service sectors on account of continued positive trends in the labour market and elevated domestic demand. A vigorous impetus to GDP growth is also likely to come from construction, given the announcements of new projects, while in the case of agriculture we assumed that the yields would be at the level of the multi-annual average.

Similarly to the previous projection, the risks to the GDP projection are assessed to be symmetric, whereas, in the short run, the risks arising from the international environment are titled to the downside and those from the domestic environment to the upside. In the medium run, risks to the GDP projection are assessed as symmetric.

The key risk emanating from the international environment concerns the pace of growth in the euro area, our most important foreign trade partner, and the relating pace of growth in the countries of Central and Southeast Europe, with which the euro area, and increasingly Serbia as well, are fostering strong economic links. Although at the start of the year euro area growth was faster than expected, the still present trade and geopolitical tensions are having an adverse effect on investor confidence, which in the short run negatively affects economic growth. The slowdown of the pace of growth in the euro area could result in slower growth in Serbia's exports and the subsequently slower growth of production in manufacturing, as well as a potential slower investment inflow. To an extent, the uncertainty also relates to the negative effect of 100% tariffs on products delivered to Kosovo and Metohija, which, if they are maintained,

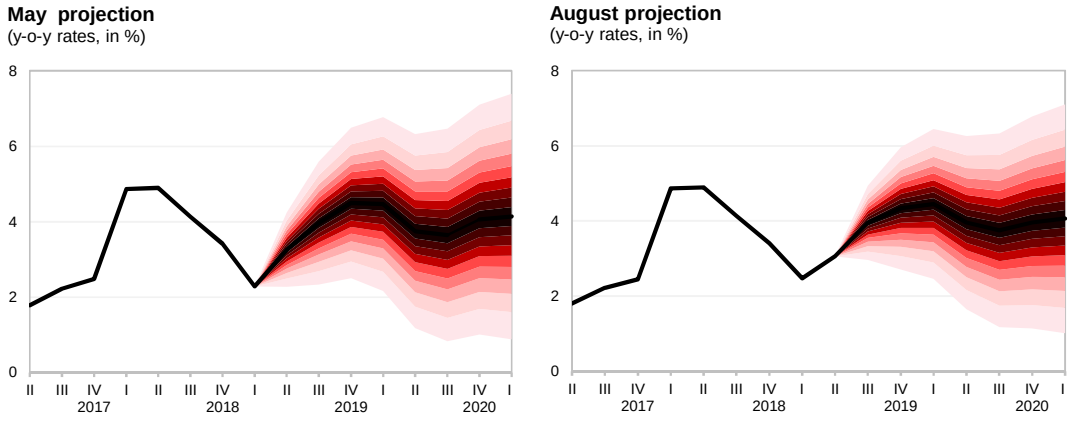
could lead to smaller production in manufacturing, notably of food products.

In addition to the trade channel, as a small and open economy, Serbia is also under the impact of **capital flows and relations between the major currencies in the international financial market**. Unlike the previous projection, when it was still uncertain to what extent the pace of normalisation of monetary policies of leading central banks would continue, the Fed and ECB first announced a slower increase in their key interest rates, but thereafter the possibility of a new monetary accommodation cycle became increasingly certain, materialising in July in Fed's case. Therefore, the risks to the GDP projection on these grounds are assessed as symmetric. It is also noteworthy that Serbia – owing to preserved macroeconomic stability, narrowed internal and external imbalances, increased domestic savings and lesser needs for external borrowing – reduced its exposure to potential external shocks in the international financial market.

The risks to the GDP growth projection are also associated with the **prices of primary commodities, notably oil, base metals and cereals**. As Serbia is a net importer of oil, rising oil prices could spill over to a lower disposable income and higher costs of operation, while falling oil prices would have an opposite effect. On the other hand, when it comes to prices of base metals (particularly steel and copper) and cereals, Serbia, as a net exporter, will benefit from their potential rise in the global market. However, as the movement in these prices in the global market is possible in both directions, the risks on these grounds are assessed as symmetric.

Unlike the risks from the international environment, the short-term effect of some domestic factors on GDP growth is assessed to be tilted to the upside. This concerns

Chart V.0.19 **Current vs. previous GDP growth projection**



Source: NBS.

primarily the favourable effects of **faster than expected investment growth** in 2018 and as of the start of 2019. As investment is channelled predominantly to tradeable sectors, its activation is likely to contribute to the acceleration of exports, notably of manufacturing. In addition, the effects of this investment could produce more favourable than expected trends in construction, where, in addition to the continued intensive investment in infrastructure, positive trends in the real estate market prevail.

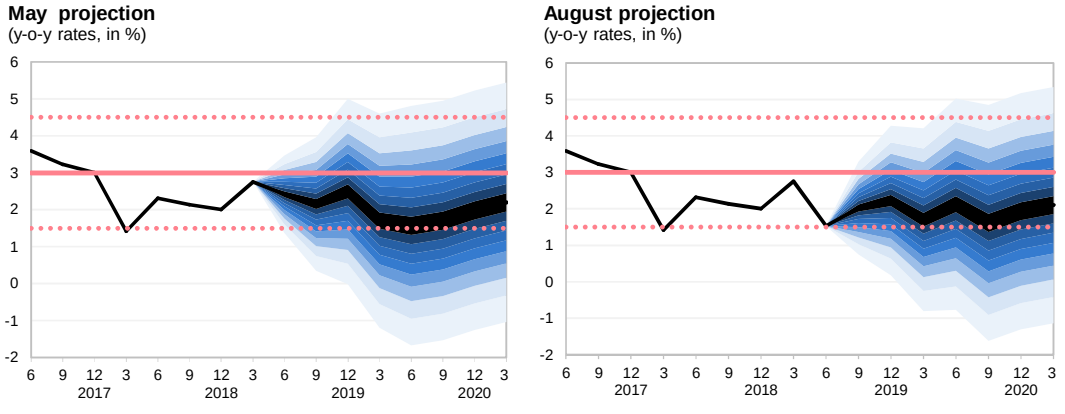
A risk to the GDP growth projection is also associated with **agricultural production** in 2019, assumed to fall by around 5% due to the high base from 2018. As we still lack reliable data on the yields of key crops, which are under a strong impact of volatile weather, deviations may occur in both directions, which is why the risks on these grounds are judged to be symmetric.

Comparison and outcome of inflation projections

The new medium-term projection is lower than the May *Inflation Report* projection until the end of the year, and then somewhat higher until the end of the projection horizon. The main reason for lower projected inflation until the end of the year is a lower than expected increase in the prices of vegetables in May and June, which pushed down the projected y-o-y inflation rates until the end of the year, but also pushed them up in the coming year on account of the base effect.

The disinflationary impact of the global oil price is somewhat stronger in the new projection. In the period since the last projection it fell from USD 71 to USD 62 per barrel. According to the latest available futures, the global oil price should have a mildly downward trajectory

Chart V.0.20 **Current vs. previous inflation projection**



Source: NBS.

relative to the current level and until the end of the projection horizon, this trajectory will be at a lower level than in the May projection. As a result, the projected hike in the prices of petroleum products in the coming year will be at a level lower than in the last medium term projection.

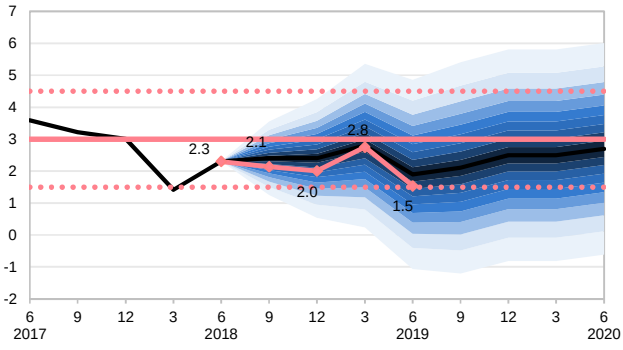
Continuing appreciation pressures are pushing the inflation projection down and on that account the projected hike in the prices of non-food products was somewhat lower than in the May projection. Additionally, lower inflation in the international environment through lower imported inflation, will hamper the hike in the prices of non-food products and services.

On the other hand, projected food inflation is somewhat higher on account of higher than expected global prices of primary agricultural commodities and consequently higher costs of food production and on account of a hike in the price of pork in the global market, spurred by the rising demand from East Asia.

The assumption about the rise in administered prices remained unchanged and its impact on projection deviations was neutral.

Last year inflation moved within the range of the August 2018 projection. It moved on the trajectory which was somewhat below the path of the central inflation projection from August 2018, to find itself around the projected level at the end of the observed period (Q2 2019). A more inflationary impact than the one assumed in last year's projection was that of the prices of vegetables due to a weaker yield of main crops both in Serbia and the international environment, while administered prices, global oil prices and imported prices exerted a disinflationary influence.

Chart V.0.21 **Achievement of August 2018 inflation projection**
(y-o-y rates, in %)



Source: NBS.

Table A
Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Q1 2019	Q2 2019
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	6.7	6.2	5.4	5.3	5.3	5.4
FX reserves/short-term debt	177.0	265.1	250.6	162.6	220.6	191.2	299.9	237.3	268.6	294.0	256.4	234.0	200.1	276.9	229.6	
FX reserves /GDP	22.1	34.8	30.5	22.9	32.6	31.7	34.0	32.4	30.7	27.9	29.1	27.8	25.4	26.3	26.5	27.7
Debt repayment/GDP	4.7	9.7	9.6	10.1	12.1	11.3	11.7	12.3	12.6	13.3	11.1	12.3	10.9	11.3	8.8	
Debt repayment/exports of goods and services	19.8	36.2	37.5	37.5	48.8	37.5	37.3	36.0	33.0	32.7	25.2	25.9	22.2	22.8	16.8	
EXTERNAL SOLVENCY INDICATORS (in %)																
External debt/GDP	56.2	55.2	55.1	58.8	68.6	74.5	68.1	76.1	70.4	72.4	73.5	72.1	65.3	62.7	62.8	
Short-term debt/GDP	12.5	13.1	12.2	14.1	14.8	16.6	11.3	13.7	11.4	9.5	11.3	11.9	12.7	9.5	11.5	
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	166.8	152.4	132.4	126.4	124.8	
FINANCIAL RISK EXPOSURE INDICATORS (in %)																
FX reserves/M1	290.3	356.1	306.7	300.4	393.4	416.6	429.6	402.1	330.4	278.1	250.2	207.3	176.2	168.0	183.3	185.2
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	196.6	185.0	171.4	176.6	198.1
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	67.1	73.0	74.7	78.0	65.1	75.3	78.0	84.5	87.1	91.8	96.2	100.7	106.3	109.0	116.2	113.9
MEMORANDUM: (in EUR million)																
GDP[1]	22,276	25,906	31,551	35,701	32,486	31,546	35,432	33,679	36,427	35,467	35,716	36,723	39,183	42,780	10,171	11,334[3]
External debt	12,520	14,291	17,382	20,982	22,272	23,509	24,123	25,645	25,644	25,679	26,234	26,494	25,574	26,836	27,138	
External debt servicing	1,054	2,513	3,039	3,594	3,922	3,564	4,154	4,130	4,595	4,728	3,960	4,508	4,285	4,849	898	
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	10,205	9,962	11,262	11,440	12,146
Short-term debt[2]	951	968	1,044	1,832	1,852	1,758	612	455	196	99	303	676	893	1,481	1,275	
Current account balance	-1,778	-2,356	-5,474	-7,126	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-1,234	-1,075	-2,051	-2,223	-910	-716

CREDIT RATING (change of rating and outlook)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2017	2018
	July/May	Feb	July	March/ Dec	Dec	Nov	March	Aug	July	Jan	Dec	Jan/March/ June/Dec	March	Dec	Dec
S&P	BB- /stable	BB- /positive	BB- /stable	BB- /negative	BB- /stable		BB /stable	BB- /negative				BB- /positive		BB /stable	BB /positive
Fitch	BB- /stable			BB- /negative		BB- /stable		BB- /negative		B+ /stable	B+ /positive	BB-/stable		BB /stable	
Moody's									B1 /stable			B1 /positive	Ba3 /stable		

Methodological notes:

Foreign exchange reserves/imports of goods and services (in months) – ratio of end-of-period foreign exchange reserves to average monthly imports of goods and services during period under review.
Foreign exchange reserves/short-term debt (in %) – ratio of foreign exchange reserves to stock of short-term debt at remaining maturity at end-of-period.
Foreign exchange reserves/GDP (in %) – ratio of end-of-period foreign exchange reserves to GDP.
Debt repayment/GDP (in %) – ratio of debt repayment (excl. early repayment of a part of debt to London Club creditors) to GDP during period under review.
Debt repayment/exports (in %) – ratio of debt repayment (excl. early repayment of a part of debt to London Club creditors) to exports of goods and services during period under review.
External debt/GDP (in %) – ratio of end-of-period outstanding debt to GDP.
Short-term debt/GDP – ratio of end-of-period short-term debt at remaining maturity to GDP.
External debt/exports (in %) – ratio of end-of-period outstanding debt to annual value of exports of goods and services.
Foreign exchange reserves/M1(in %) – ratio of foreign exchange reserves to money supply at end-of-period.
(Exports + imports)/GDP (in %) – ratio of value of exports and imports of goods and services to GDP during period under review.

[1] According to ESA 2010.

[2] At original maturity.

[3] NBS estimate.

Notes:

1. The Statistical Office revised GDP data for the period 2005–2017, which led to a change in the share of macroeconomic indicators in GDP.

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

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.

4. 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.

5. In September 2010, the methodology of external debt statistics was changed – public sector external debt now includes liabilities under SDR allocation (EUR 479.8 mn) used in December 2009. Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 982.0 million, of which EUR 425.9 million relating to domestic banks and EUR 556.1 million to domestic enterprises).

6. External 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	2016	2017	2018	Q1 2019	Q2 2019
Real GDP growth (in %)[1]	5.5	4.9	6.4	5.7	-2.7	0.7	2.0	-0.7	2.9	-1.6	1.8	3.3	2.0	4.3	2.5	3.1[6]
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	1.6	3.0	2.0	2.8	1.5
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	10,205	9,962	11,262	11,440	12,146
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	15,728	17,385	19,312	21,238	5,362	5,907
- 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	8.8	10.5	11.1	10.0	10.6	10.7
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	18,643	19,597	22,343	25,392	6,461	7,008
- 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	3.0	5.1	14.0	13.6	12.1	12.2
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	-1,234	-1,075	-2,051	-2,223	-910	-716
as % of GDP	-8.0	-9.1	-17.3	-20.0	-6.3	-6.5	-10.3	-10.9	-5.8	-5.6	-3.5	-2.9	-5.2	-5.2	-9.0	-6.3
Unemployment according to the Survey (in %)[7]	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	19.2[7]	17.7	15.3	13.5	12.7	12.1	
Wages (average for the period, in EUR)[8]	210.4	257.8	347.1	402.0	337.8	331.8	372.5	366.1	388.5	379.8	367.9	374.5	383.9	419.7	454.5	466.3
RS budget deficit / surplus (in % of GDP)[4]				-1.6	-3.0	-3.2	-3.8	-5.6	-4.9	-5.9	-2.7	-0.2	0.7	0.6	1.3	0.4
Consolidated fiscal result (in % of GDP)[4]	1.1	-1.4	-1.8	-2.5	-4.2	-4.3	-4.5	-6.4	-5.1	-6.2	-3.5	-1.2	1.1	0.6	0.9	0.5
RS public debt, (central government, in % of GDP)[9]	47.6	33.9	27.9	26.8	30.9	39.5	42.8	52.9	56.0	66.2	70.0	67.8	57.9	53.8	51.0	51.4
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	111.29	107.50	100.28	104.06	104.95
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	117.14	99.12	103.39	105.00	103.77
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	123.12	121.34	118.27	118.23	117.97
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	123.47	118.47	118.19	117.97	117.91
MEMORANDUM:																
GDP (in EUR million)[5]	22,276	25,906	31,551	35,701	32,486	31,546	35,432	33,679	36,427	35,467	35,716	36,723	39,183	42,780	10,171	11,334[6]

[1] At constant prices of previous year. Data for 2018 is estimate of Statistical Office based on the sum of four quarters.

[2] Retail prices until 2006.

[3] Starting from 2007 data on balance of payments (current account, 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] New methodology of Labour Force Survey since 2014.

[8] By 2017, wages according to the old methodology. Since 2017, wages are published according to the new methodology and data are based on Tax administration evidence. For Q2 2019 wages are average of April-May. For conversion of wages from RSD to Euros used exchange rate RSD/EUR average of the period.

[9] Data on the share of public debt in GDP were downloaded from the website of the Public Debt Administration.

Notes:

1. The Statistical Office revised GDP data for the period 2005-2017, which led to a change in the share of macroeconomic indicators in GDP.
2. Data are subject to corrections in line with official data sources.
3. Source for the data on unemployment: Labour Force Survey, Statistical Office.
4. Source for public debt: MoF.

Index of charts and tables

Charts

Tables

Charts in text boxes

Tables in text boxes

Executive Board meetings and changes in the key policy rate

2018

Date	Key policy rate (p.a, in %)	Change (in basis points)
11 January	3.50	0
8 February	3.50	0
8 March	3.25	-25
12 April	3.00	-25
10 May	3.00	0
7 June	3.00	0
12 July	3.00	0
9 August	3.00	0
6 September	3.00	0
8 October	3.00	0
8 November	3.00	0
6 December	3.00	0

2019

Date	Key policy rate (p.a, in %)	Change (in basis points)
10 January	3.00	0
7 February	3.00	0
7 March	3.00	0
9 April	3.00	0
9 May	3.00	0
6 June	3.00	0
11 July	2.75	-25
8 August	2.50	-25
12 September		
10 October		
7 November		
12 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 6 June 2019

At its meeting today, the NBS Executive Board voted to keep the key policy rate at 3.0%.

In making the decision, the Executive Board was guided primarily by the outlook for inflation and its factors in the domestic and international environment.

Keeping the key policy rate on hold, the Executive Board stated that inflation has been firmly under control for six years in a row and that it will remain so going forward. Consistent with NBS expectations and announcements, y-o-y inflation continued to move within the target band (3.0±1.5%), measuring 3.1% in April. The Board judges this to be its peak value for this year. Inflation is expected to embark on a downward path from May onwards, moving close to the lower bound of the target band in the first half of 2020 and heading steadily back towards the target midpoint in the period thereafter. Low inflationary pressures are also indicated by the persistently low and stable core inflation and inflation expectations of the financial and corporate sectors anchored around the 3.0% target for both one and two years ahead.

Based on the analysis of current macroeconomic trends, the Executive Board assessed that caution in monetary policy conduct was still warranted, chiefly because of persistent uncertainty in the international environment. New protectionist measures and trade tensions fuel uncertainty in the international commodity and financial markets. Also, global oil price has been volatile and its future movements remain unpredictable due to numerous factors on both supply and demand side. The normalisation of monetary policies of leading central banks, the Fed and the ECB, will be slower than expected due to the slowdown in global economic growth and inflation. It remains uncertain, however, to what extent the normalisation would diverge from market expectations, which might trigger volatility in global capital flows.

The Executive Board points out that the resilience of our economy to potential adverse effects from the international environment has increased owing to reduced internal and external imbalances and favourable macroeconomic prospects. As in the previous two years, public finances recorded a surplus in the first four months of this year and the current account deficit was fully covered by the net inflow of foreign direct investment. The Executive Board expects that economic growth this year will be led by domestic demand, i.e. investment and consumption, and that foreign direct investment, which supports the expansion of our production and export capacities, will lead to the gradual narrowing of external imbalances in the medium term.

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

Press release from Executive Board meeting held on 11 July 2019

At its meeting today, the NBS Executive Board voted to cut the key policy rate to 2.75%.

Having analysed economic developments at home and abroad and prospects going forward, the Executive Board assessed that conditions have been met to cut the key policy rate to 2.75%, its new lowest level in the inflation targeting regime. The NBS thereby provides additional support to economic growth. Inflation has been kept firmly under control for the sixth year in a row. In accordance with the Executive Board's announcements, in May it declined to 2.2% y-o-y. As underscored by the Executive Board, inflation will continue to move within the target tolerance band, most probably in its lower part, until the end of this and in the course of next year. Subdued inflationary pressures are also confirmed by the still low and stable core inflation, as well as financial and corporate sector inflation expectations, which declined further in June and are currently below the target midpoint.

Developments in the international environment are marked by slower economic growth and lower than expected inflation, which is why the ECB and the Fed first announced a slower pace of rate hikes, while now they appear increasingly likely to embark on a new round of monetary easing. The ECB extended the period over which it would keep its key interest rates on hold (at least through mid-2020) and announced other accommodative measures as well. Similarly, the Fed hasn't raised the target range for the federal funds rate since last December, though market expectations of a rate cut until the end of the year are gaining traction. A slower pace of normalisation or a new round of monetary policy easing should have a positive impact on conditions in the international financial market and on capital flows to emerging markets. Besides, the global oil price declined and futures indicate it is likely to stay close to the current level by the end of the year as well.

The Executive Board stressed that the Serbian economy's resilience to potential negative effects from the international environment has increased owing to the narrowing of internal and external imbalances and favourable macroeconomic prospects going forward. As in the past two years, public finances are posting a surplus, and in the first five months of 2019 the current account deficit has been fully covered by net FDI inflow. The Executive Board expects this year's economic growth to be driven by domestic demand, i.e. investment and consumption, and that FDIs, which contribute to the increase in production and export capacities, will result in a gradual narrowing of external imbalances in the medium term.

The next rate-setting meeting will be held on 8 August 2019.

Press release from Executive Board meeting held on 8 August 2019

At its meeting today, the NBS Executive Board voted to trim the key policy rate to 2.5%. By cutting the rate to a new lowest level in the inflation targeting regime, the NBS provides additional support to credit and economic growth.

In making the decision, the Executive Board was mainly aware of the new, August medium-term inflation projection and the expected movements of other macroeconomic indicators at home and abroad in the period ahead. According to the August projection as well, inflation will be firmly under control as in previous years, and will continue to trend within the bounds of the target tolerance band (3.0±1.5%) until the end of the projection horizon i.e. over the next two years – most probably in its lower part of the target band. Y-o-y inflation in June decreased to 1.5%, confirming the announcements by the Executive Board that it would slow down as of May. Subdued inflationary pressures are also confirmed by still low and stable core inflation, as well as financial and corporate sector inflation expectations which undershot the 3.0% target for both one and two years ahead.

In addition to domestic macroeconomic conditions conducive to monetary policy pursuit, the Executive Board's decision on the rate cut was also made in light of international developments, notably the slowdown in global trade and growth and the increasingly clear signals hinting at monetary policy accommodation, followed by actual measures by leading central banks. As had been expected, the Fed lowered the key rate at end-July, while the ECB announced an unchanged or lower level of its key interest rates at least through mid-2020, with a new programme of longer-term refinancing operations as of September. This will help maintain favourable global financial conditions longer than initially expected, which should have a positive impact on capital flows toward emerging economies. However, there are still factors warranting caution in monetary policy conduct, the main ones being global trade tensions, a possibility that monetary policy decisions of leading central banks might deviate from market expectations in the coming period, as well as movements of oil prices and other primary commodities in the global market.

The Executive Board points out that the resilience of our economy to potential adverse effects from the international environment has increased owing to reduced internal and external imbalances and favourable macroeconomic prospects. As in the previous two years, public finances recorded a surplus in the first half of 2019 and the current account deficit was fully covered by the net inflow of foreign direct investment. The Executive Board expects that economic growth this year will be led by domestic demand, i.e. investment and consumption, and that foreign direct investment, which supports the expansion of our production and export capacities, will lead to the gradual narrowing of external imbalances in the medium term.

At today's meeting, the Executive Board adopted the August Inflation Report, which will be presented to the public on 14 August. On that occasion, we will give a detailed account of monetary policy decisions and underlying macroeconomic trends.

The next rate-setting meeting will be held on 12 September.

CIP - Каталогизација у публикацији
Народна библиотека Србије, Београд

336.71(497.11)

INFLATION Report / National Bank of Serbia. - 2006- . - Belgrade (Kralja Petra 12) : National Bank of Serbia, 2006- (Beograd : Zavod za izradu novčanica i kovanog novca "Topčider") . - 30 cm

Tromesečno
ISSN 1820-9394 = Inflation Report (National Bank of Serbia)
COBISS.SR-ID 155775244