National Bank of Serbia

November 2009

INFLATION REPORT

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Introductory note

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

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

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

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

The November *Inflation Report* was adopted by the NBS Monetary Policy Committee in its meeting of 13 November 2009.

Earlier issues of the *Inflation Report* are available on the NBS website (http://www.nbs.rs).

Monetary Policy Committee of the National Bank of Serbia:

Radovan Jelašić, *Governor*

Ana Gligorijević, *Vice Governor*

Bojan Marković, *Vice Governor*

Mira Erić-Jović, *Vice Governor*

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I. Overview

In the year to date, inflation has been moving within the target band.

Inflation declined in Q3 2009, trending closer to the lower bound of the target band. All inflation components, most notably prices of agricultural products, recorded lower than expected growth. The disinflation process was also aided by a significant slowdown in regulated price growth, as well as by lower core inflation resulting from the drop in inflation expectations, decline in the prices of agricultural products, low aggregate demand and stabilisation of the exchange rate.

Low aggregate demand represents the key disinflationary factor in the medium term.

Low aggregate demand continues to be the key disinflationary factor in the medium term. This is supported by the low corporate and government investment activity, and the fact that there is a freeze on public sector wages and pensions which constitute an important source of personal consumption. As a demand-side measure, output gap remains negative. However, it recorded a negligible decline in Q3 amid a certain pick-up in lending activity, a more inflationary financing of the fiscal deficit than a quarter earlier, and a mild recovery of global demand.

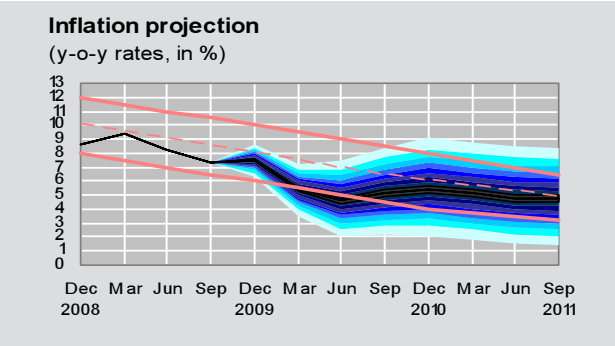
The exchange rate has remained stable despite downward revision of the key policy rate and an increase in dinar liquidity.

The exchange rate of the dinar remained stable despite lowering of the key policy rate and of the share of foreign currency required reserves to be allocated in dinars. This stability came about as a result of a drop in risk premium and an increase in banks' foreign liabilities and household foreign currency savings. As the international economic flows contracted, corporate demand for foreign exchange weakened as well. The risks and uncertainties regarding the exchange rate outlook eased further following successful completion of the second review of the arrangement with the IMF and the additional allocation of SDRs into our foreign exchange reserves.

Economic activity shows a mild recovery.

Q3 saw signs of a mild economic recovery. GDP rose for the first time in a year, and NAVA growth stepped up. Industrial output increased mainly as a result of temporary restoration of the black metallurgy production. The drop in GDP in 2009 will be softer than anticipated at the time of the previous Inflation Report and will measure around 2.8%.

In H1 2010 inflation is projected to revolve around the lower bound of the target band, coming closer to its midpoint later on.



In Q4, consumer prices are expected to go up by around 1.2% primarily on the back of seasonally-induced growth in agricultural product prices. The October and November targets will most likely be undershot. However, inflation is expected to retreat within the target band by year-end and settle around its midpoint at 7.5% year-on-year (6–10% target band). Based on the November medium-term projection, in H1 2010 inflation will revolve around the lower bound of the target band, after which it will trend closer to its midpoint. The drop in demand, along with a freeze on public sector wages and pensions, will be the key factor of price stability in the medium run.

Successful completion of negotiations with the IMF has significantly lessened the risks to inflation outlook.

The positive outcome of negotiations on the continuation of arrangement with the IMF has significantly lessened the risks to inflation outlook, as it will contribute to a further decrease in the risk premium. The idea of a VAT increase has been dropped altogether. The key risks to the current projection are uncertainties regarding movements in international oil prices, regulated prices and agricultural product prices. Although it is certain that there will be no major adjustment in regulated prices until the end of the year, the risk remains that the 9±2% regulated price growth agreed for 2010 will be overshot.

The key policy rate is more likely to be lowered in the coming period than kept on hold.

Taking into account the current projection and the underlying risk factors, the NBS Monetary Policy Committee judges that the key policy rate is more likely to be lowered in the coming period than kept on hold (10%).

II. Inflation developments

Declining on the previous two quarters, inflation moved within the target range and was lower than projected mainly on account of the sharper than seasonally expected drop in agricultural producer prices, a marked slowdown in regulated price growth and lower core inflation.

At the quarter-end, y-o-y consumer price growth moved below the midpoint of the target band (7.3%) and is likely to reach around 7.5% at end-2009.

Quarterly headline inflation rates continued down, with consumer prices falling 0.7%. The negative inflation recorded in July (–0.9%) and August (–0.1%) came from a steeper seasonal drop in agricultural producer prices, which offset the growth in market determined and regulated prices. In September, due to the seasonal increase in agricultural producer prices, inflation was positive (0.3%).

The inflation outturn (–0.7%) was lower than forecast in the previous Report (0%). Deviations from the previous estimate were recorded with all three components of headline inflation (core inflation, agricultural producer and regulated prices). A fall in agricultural producer prices was larger than seasonally expected due to favourable weather and longer season. Regulated price growth continued down. Lower inflation expectations, falling prices of agricultural products and declining aggregate demand, as well as stabilisation of the exchange rate impacted on slower core inflation. The overall decline in consumer prices was aided mainly by movements in agricultural producer prices (–1.6 pp), market determined prices (0.6 pp) and regulated prices (0.3 pp). Declining to 7.3% at end-Q3, y-o-y headline inflation came to the lower bound of the target range (6.5–10.5%).

Table II.0.1 **Indicators of price growth**
(growth rates, in %)

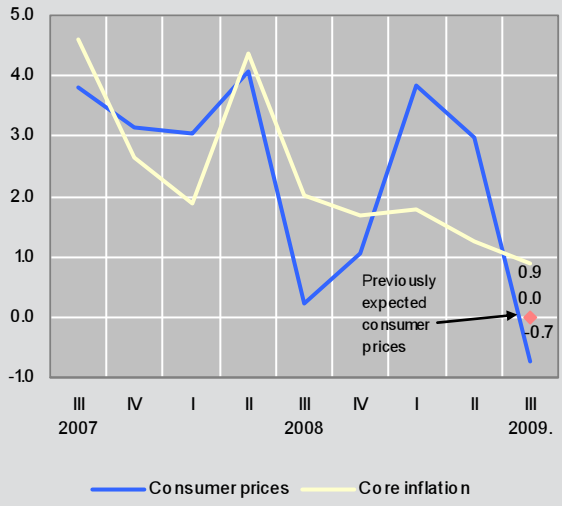
	XII 2008 / XII 2007	III 2009 / III 2008	VI 2009 / VI 2008	IX 2009 / IX 2008
Consumer prices	8.6	9.4	8.3	7.3
Core inflation	10.3	10.2	6.9	5.7
Retail prices	6.8	9.9	9.8	9.5
Cost of living	7.9	9.1	7.8	7.1
Industrial producer prices	9.0	4.9	6.6	5.3
Agricultural producer prices	13.5	0.2	-9.4	-8.9

At end-Q3, y-o-y price growth was lower than in the previous two quarters.

Prices under direct or indirect government regulation slowed significantly from the previous two quarters (9.1% and 4.4%) to 1.1%, on the back of a smaller growth in petroleum product prices, absence of the expected cigarette price hike and lower prices of medicaments. Raised and lowered on two occasions, petroleum product prices reached 2.3%. Y-o-y regulated price growth touched 11.6 % at end-Q3 (or 15.1% in the year to September).

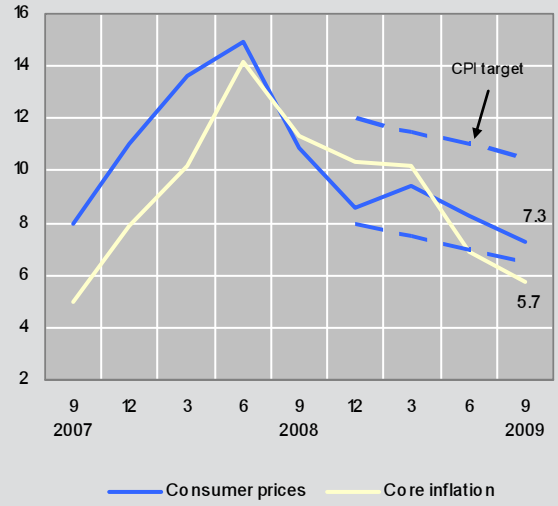
Core inflation was lower than expected, reaching 0.9% in Q3. The deviation from the forecast took place due to the unexpectedly low rate in September. After relatively high

Chart II.0.1 **Movements in prices**
(quarterly growth, in %)



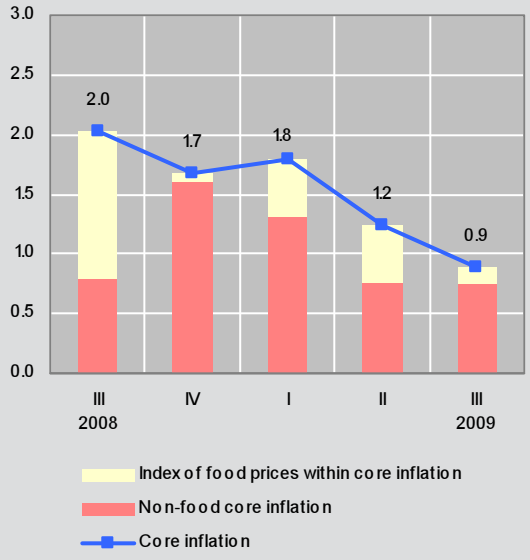
A decline in headline inflation was steeper than that in core inflaion. Headline inflation went down due to a drop in agricultural producer prices.

Chart II.0.2 **Movements in prices**
(y-o-y growth, in %)



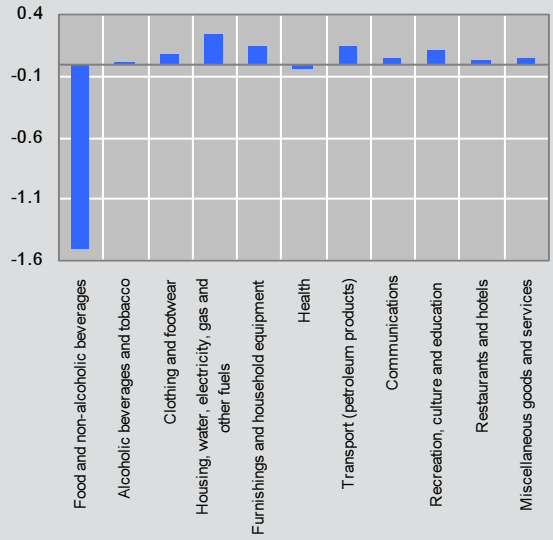
Y-o-y growth in headline and core inflation slowed down in Q3, with core inflation being much lower.

Chart II.0.3 **Contribution to core inflation**
(in percentage ponts)



The contribution of rising food prices to core inflation growth was lower in Q3 than in Q2.

Chart II.0.4 **Contribution of individual commodity groups to consumer price growth rate in Q3**
(in percentage points)



The strongest impetus to declining prices in Q3 came from a reduction in prices of food and non-alcoholic beverages.

Table II.0.2 **Consumer price growth by component**
(by quarter, in %)

	2008		2009		
	Q3	Q4	Q1	Q2	Q3
Consumer prices	0.2	1.1	3.8	3.0	-0.7
Core inflation	2.0	1.7	1.8	1.2	0.9
Prices of agricultural products	-20.1	11.4	4.7	13.1	-18.5
Regulated prices	2.1	-3.1	9.1	4.4	1.1
Electricity	8.9	0.0	0.0	0.0	0.0
Petroleum products	-11.2	-24.2	16.9	17.9	2.3
Gas for households	-0.2	55.6	-0.8	0.1	0.0
Utilities	1.1	4.5	12.8	3.1	6.0
Social welfare services	1.1	2.9	0.9	1.8	3.3
Transport services (regulated)	5.1	0.4	26.6	0.4	0.0
Postal and telecommunications services	0.0	0.7	10.1	0.0	1.9
Bread	-1.2	-0.8	-0.7	-4.1	0.6
Cigarettes	10.4	0.0	15.0	0.0	0.0
Medications	0.0	-3.2	10.1	10.3	-1.3
Other	0.8	0.0	0.7	9.7	0.1

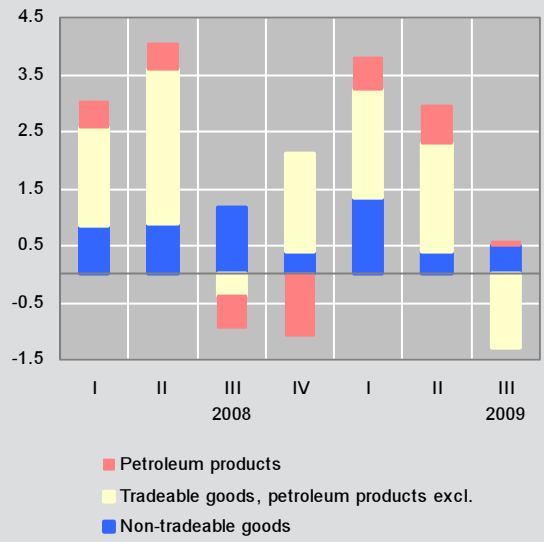
The steepest drop was recorded for prices of agricultural products and medicaments.

Table II.0.3 **Contribution to consumer price growth**
(by quarter, in percentage points)

	2008		2009		
	Q3	Q4	Q1	Q2	Q3
Consumer prices	0.2	1.1	3.8	3.0	-0.7
Core inflation	1.3	1.1	1.2	0.8	0.6
Prices of agricultural products	-1.8	0.8	0.4	1.0	-1.6
Regulated prices	0.5	-0.8	2.3	1.1	0.3
Electricity	0.6	0.0	0.0	0.0	0.0
Petroleum products	-0.6	-1.1	0.6	0.7	0.1
Gas for households	0.0	0.2	0.0	0.0	0.0
Utilities	0.0	0.1	0.4	0.1	0.2
Social welfare services	0.0	0.0	0.0	0.0	0.0
Transport services (regulated)	0.1	0.0	0.3	0.0	0.0
Postal and telecommunications services	0.0	0.0	0.2	0.0	0.0
Bread	0.0	0.0	0.0	0.0	0.0
Cigarettes	0.4	0.0	0.6	0.0	0.0
Medications	0.0	-0.1	0.3	0.3	0.0
Other	0.0	0.0	0.0	0.1	0.0

Consumer price decline in Q3 was driven primarily by the drop in agricultural product prices.

Chart II.0.5 **Contribution to quarterly consumer price growth**
(in percentage points)



Albeit negative, the contribution of tradeables prices to headline inflation was high, whereas the contribution of non-tradeables increased to a lesser extent.

figures were recorded by end-Q2 and throughout July and August (0.4–0.6%), core inflation touched 0.1% in Septem ber. Such a low outtur n was due to the decline in fo od prices (for the first time since April) prompted by lower prices of sunflower oil and their reversion to pre-hike levels (–0.2 pp). Core inflation growth was due mainly to rising prices of non-food products and services (0.8 pp). Excluding food prices, relatively high core inflation growth remained unchanged from Q2 (1.4%). Growth in food prices (included in the measure of core inflation) was much lower than in Q2, and was mainly determined by the rising prices of fresh meet and non-alcoholic beverages (0.1 pp). Y-o-y core inflation slowed down to 5.7% at end-Q3.

The decline in agricultural producer prices was steeper than expected (18.5%) but broadly in line with favoura ble weather conditions and extended season. Their y-o-y growth came to 7.4%.

Contribution of tradeables prices to headline inflation remained high, albeit declining on the previous two quarters due to a fall in agricultural producer prices. On the other hand, the contribution of non-tradeables was somewhat higher compared to Q2.

Expectations for Q4

Consumer price growth in Q4 is estimated to reach around 1.2%. At the same time, rising agricultural producer prices will contribute most to overall price growth (0.7 pp), while the contribution of market-determined and regulated prices is likely to be lower (0.4 and 0.2 pp respectively). In line with this, y-o-y consumer price growth will reach around 7.5% at the year-end. The October and November inflation targets will most likely be undershot, albeit on a temporary basis, meaning that the end-year inflation will probably move somewhat below the midpoint.

Prices under direct or indirect government regulation are likely to rise by around 0.8%, signifying a further slowdown in quarterly growth rates of these groups of products in place since early 2009. The strongest growth is expected with prices of petroleum products, while medicament prices are likely to go down.

The major risk to the short-term projection may com e from rising regulated prices, mainly petroleum product prices. Furthermore, some price hikes, planned fo r the beginning of 2010 may materialise even earlier (e.g. the cigarette price hike in December).

Table II.0.4 **Major revisions of regulated prices expected in Q4**

	Growth rate (in %)	Contributions to retail price growth (p.p.)
Petroleum products	4.7	0.2
Utilities	1.5	0.1
Medications	-2.5	-0.1

Regulated price growth is expected to slow further.

In Q4, core inflation is expected to be lower than in Q3. It estimated at around 0.5%, based on the assumption that growth in food prices, included in the measure of core inflation, will slow down until the year-end due to good agricultural year and falling prices of agricultural commodities (which was recorded already in September) and that the same factors in place in Q3 will continue into the next quarter. According to expert announcements, a cut in meat prices could be expected some time before the New Year.

Agricultural producer prices are likely to rise by around 9.4% in Q4, exerting upward risk to the projection.

Inflation expectations

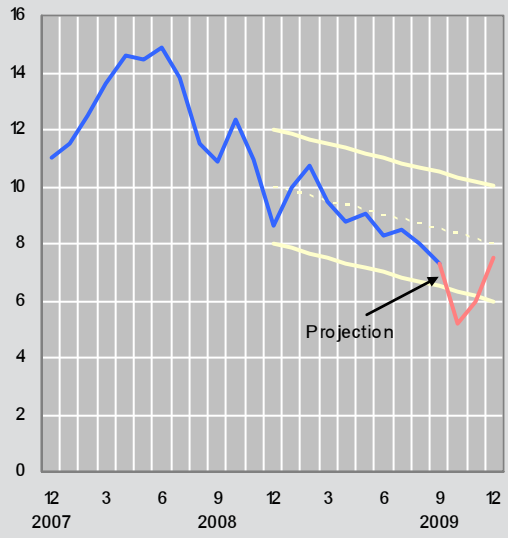
One-year ahead inflation expectations eased, but remained relatively high compared to targeted inflation.

As indicated by the Strategic Marketing Survey, one-year ahead inflation expectations of financial and trade union sectors remained unchanged from end-Q2 (10% and 12% respectively), while expectations of agricultural and household sectors declined – from 12% in June to 10% in September.

According to results of the October survey conducted by the Strategic Marketing Agency, one-year ahead inflation expectations of the financial sector declined from September to 9%. Expectations of trade unions declined as well, while those of corporate and household sectors remained unchanged from September.

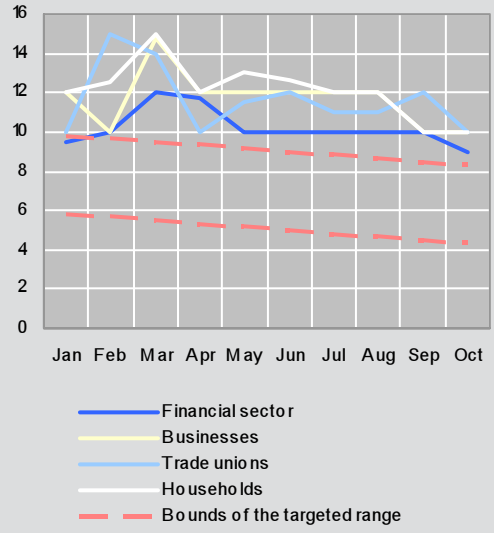
Despite a favourable influence of all factors (low aggregate demand, exchange rate stabilisation, declining risk premium and lower uncertainties), one-year ahead inflation expectations remain above the upper bound of the target range.

Chart II.0.6 **Short-term inflation projection**
(y-o-y growth, in %)



Q4 is likely to see a fall in y-o-y inflation below the lower bound and its restoration to the midpoint.

Chart II.0.7 **Expected and targeted inflation in 2010**



Source: *Strategic Marketing Research.*

One-year ahead inflation expectations of all sectors are on the decline.

According to the Reuters survey of bank dealers, one-year ahead inflation expectations declined over Q3 (9%, 8.6% and 8% in July, August and September respectively). They were further lowered in October (7.8 %), moving with the target range for 2010.

Inflation expectations in the coming period are likely to be stable in light of the significant decline in inflationary pressures and the arrangement reached with the IMF for the next year.

Will food prices continue to be a disinflationary factor?

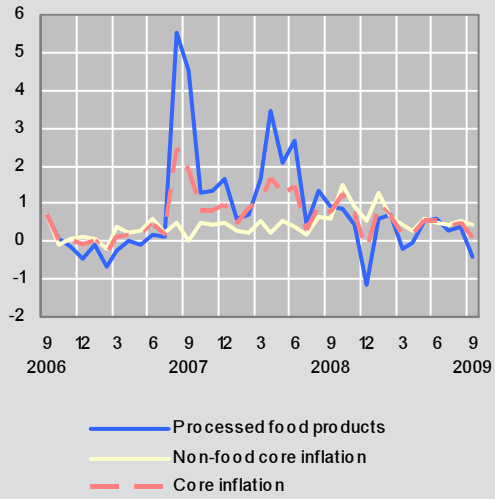
In the previous years inflation movements were under a significant influence of processed food prices. In the second half of 2007 and the first half of 2008 these prices generated strong inflationary pressures, but from mid-2008 started working in the opposite direction. The trajectory they will take in the coming period is one of the important elements of the new inflation projection.

Movements in prices of processed food largely depend on the prices of primary agricultural products, most notably wheat, corn, sunflower and sugar beat. The current agricultural year appears to have been solid, wherefore the prices of primary agricultural products have already headed down.

Thus, Serbian wheat prices fell from 15 RSD/kg in October 2008 to 9 RSD/kg in October 2009. Downward pressure came partly from the poorer quality of domestic crop compared to last year[1], but also from the good wheat crops around the world. Judging by the current prices of wheat futures in the world's major commodity exchanges (Chicago, Paris, Budapest), international wheat prices are likely to remain stable over the next six months.

Although domestic wheat prices have been on a constant decline over the past two years, bread prices tended not to move a great deal. Bread producers account for the price rigidity by an increasingly smaller share of wheat flour in the structure of retail bread prices and an increasingly larger share of energy costs (electricity, natural gas, oil, which rose over the past two years) and high retail margins (reaching at times as much as 20%). However, as this year's wheat crops are generally good and larger than last year, the baking industry should have sufficient quantities of input material to keep the bread prices at least unchanged for the next six-month period.

Chart 1 **Movements in core inflation components**
(monthly rates in %)



Source: Statistical Office.

The price of corn, one of the most widespread crop grown in Serbia, has a large impact on the formation of meat and meat product prices. The last closing price of this year's corn crops in the Novi Sad commodity exchange was 9 RSD/kg, which is broadly in line with price levels across the region.

In the coming period corn price movements will largely depend on the demand in the world market. Weak corn harvest expected in the EU, Russia and Ukraine and the possibly stronger corn demand could serve as a fillip to Serbia's exports, feeding through into higher corn prices. On the other hand, current prices of corn futures in the world commodity exchanges give us no reason to believe that there will be any major price growth in the next six months.

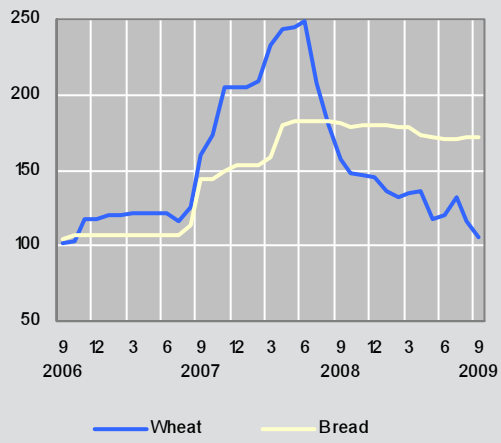
The rise in corn prices is often cited by meat product producers as the main reason for price increases. Nevertheless, it is quite noticeable that the drop in corn prices is not followed by the drop in meat prices, or if it is, the latter drop is considerably smaller (see Chart 3). This is most probably due to weak competition among domestic producers.

Still, it can be expected that meat prices will go down in the near future. Low prices of this year's corn crop will probably push down the livestock prices, creating scope for meat/meat product producers to adjust their prices down (by an estimated 10%). Downward pressures on meat prices will also come from globally dampened pork demand.

[1] At any rate, the drop in prices exceeded quality losses.

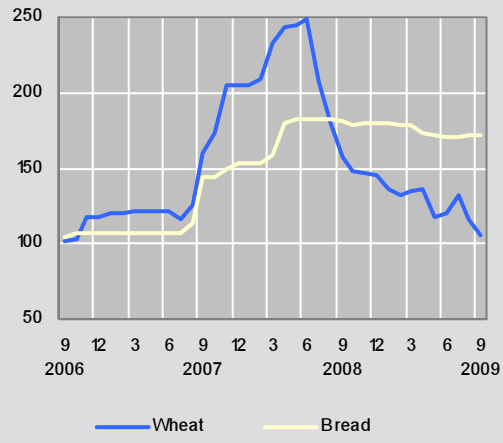
Sunflower production in Serbia is on the decline this year. Even though yields per unit area remain close to last year's, the size of land under crop is by around 17% lower. Overall sunflower production will be reduced by approximately as much. The main reasons for reducing land under sunflower crop lie in the onset of the global economic crisis, which has led to a decrease in sunflower prices worldwide, as well as in the cooking oil manufacturers' default on payments to farmers. It be noted, however, that the domestic market needs for cooking oil will be fully met even with this year's lower production, and that extra quantities will remain for export too.

Chart 2 **Bread and wheat prices - base indices**
(May 2006 = 100)



Source: STIPS* and Statistical Office.

Chart 2 **Bread and wheat prices - base indices**
(May 2006 = 100)



Source: STIPS* and Statistical Office.

The cooking oil market is the most blatant example of the positive effect of increased competition on prices. Until August 2009, two manufacturers (Dijamant and Invej) held an over 80% share of the market. In July and August, prices jumped from 90-100 RSD/l to over 120 RSD/l. The entry of a new manufacturer, equipped with state-of-the-art technology and offering a producer price of 71 RSD/l (Victoria Oil) induced other manufacturers to adjust their prices as well. The current retail prices of cooking oil range from 79 to 89 RSD/l. This negative price shock alone lowered the September core inflation by 0.2%. With stable supply of input material for the next season provided, the prices in this market are not expected to move a great deal over the next year or so.

The surface area of land cultivated with sugar beet is 26% larger than last year. Even with average yields, this year's sugar production will satisfy the needs of the domestic market, as well as of exports to the EU under the preferential quota system. The prices of sugar have been stable for a longer stretch of time (55-65 RSD/kg in the past two and a half years), making it the most price-stable product within staple foods. No major changes should therefore be expected in this respect.

Judging by all indicators, the prices of processed food are likely to continue growing at a slower pace than those of non-food products, thus producing disinflationary effects.

* STIPS – Agricultural Market Information System of Serbia.

III. Inflation determinants

1. Monetary conditions

Monetary policy was neutral in Q3. As the real depreciation of the dinar came to a halt, the degree of monetary expansiveness eased from a quarter earlier.

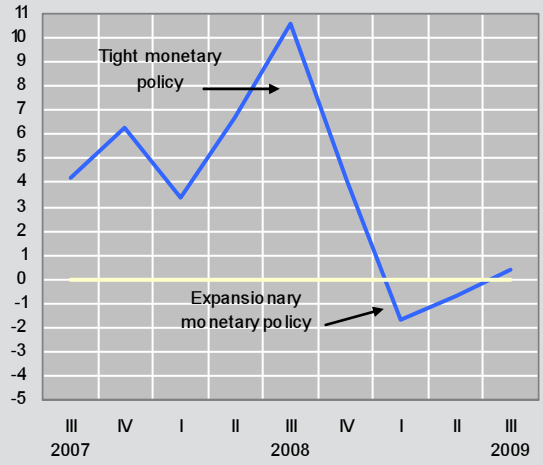
RMCI[1] points to neutral monetary policy stance in Q3.

Our expectations stated in the last Inflation Report have proved true: depreciation gap of the real exchange rate, one of the RMCI components, closed in the course of Q3 under the impact of a stable dinar and despite 0.7% deflation. As in the previous quarter, there were no major pressures on the exchange rate of the dinar – average nominal appreciation measured around 1%.

The real interest rate – the other RMCI component, hovered below the neutral level in Q3. Its trend declined in response to lower risk premium and further decrease in interest rates abroad. However, as inflation expectations remained relatively high despite the cut in the key policy rate by 100 basis points in Q3 and additional cuts by the same amount in October and November, the real interest rate slid below the neutral level by around 340 basis points.

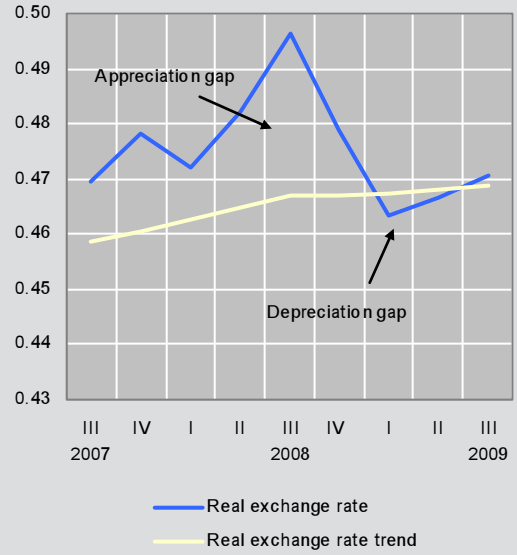
According to the results of the October Reuters survey, banks anticipate monetary easing – the average key policy rate they expect to see at end-2009 is 10.3%. That monetary easing took place already in

Chart III.0.1 **Monetary Conditions Index (MCI)**



Monetary policy was neutral.

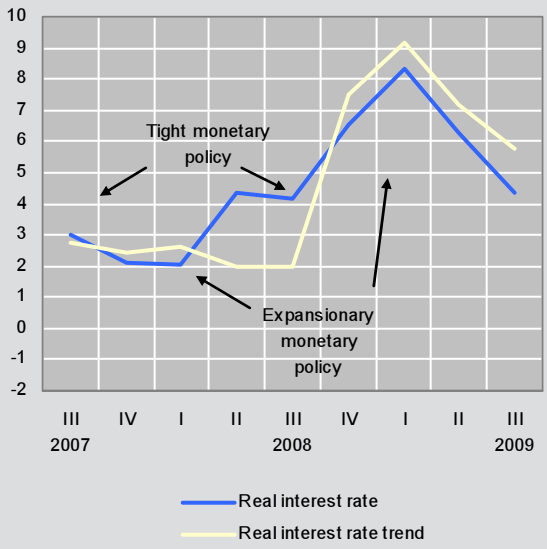
Chart III.0.2 **Real exchange rate and its trend**



Depreciation gap of the real exchange rate closed in Q3.

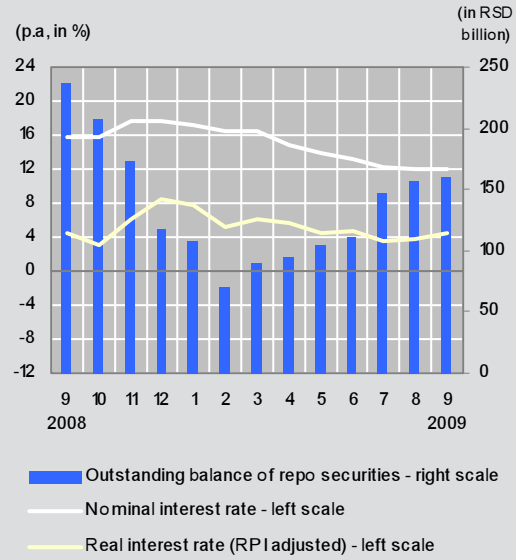
[1] Real Monetary Conditions Index.

Chart III.0.3 **Real interest rate on repo operations and its trend**



Real interest rate was running below the trend.

Chart III.1.1 **NBS open market operations**



Even despite the real decrease in the key policy rate, ample banking liquidity brought about an increase in the stock of NBS securities.

early November when the key policy rate w as cut to 10%. Based on the current inflation projection, the key policy rate will most likely be lowered further.

Interest rates

Downward revisions of the key policy rate and high dinar liquidity of banks induced a further decline in money market interest rates in Q3.

Despite downward revision of the key policy rate, from 13% to 12%, investment into NBS and treasury bills continued unabated owing to an increase in banking sector liquidity[2]. Namely, banks – signatories to the Vienna Initiative replenished their liquidity with the lowering of the share of foreign currency required reserves to be allocated in dinars. Banks' readiness to accept lower yields is also attested to by the RSD 11 billion increase in NBS repo portfolio after yet another cut in the key policy rate (to 11%) in early October.

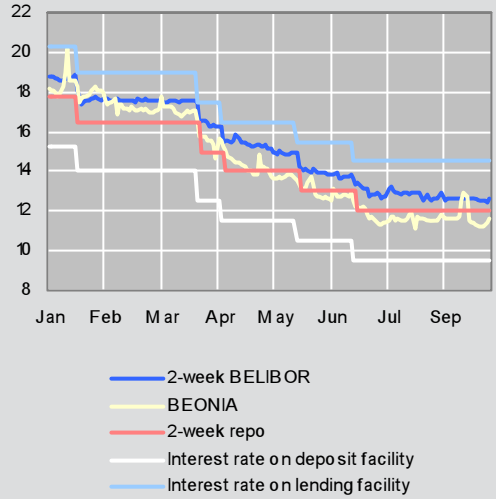
Banks' risk aversion and protracted uncertainty regarding further effects of the world financial crisis made investment of a su bstantial portion of unemployed dinar assets in NBS and treasury bills more attractive than investment into new loans.

As the decline in effective interest rate on treasury bills in Q3 (from 15.2% to 12.4% p.a.) was sharper than that in the key policy rate (from 14.1% to 12.1% p.a.) under the impact of ample bank liquidity, at the end of the quarter the effective interest rate on one-year treasury bills was the only rate higher than the key policy rate.

The yields on three-month and six-month treasury bills and two-week NBS repo bills trended closer, especially in August and September when bank liquidity was at its peak. The fact that interest rates on the treasury bills of these maturities nearly came to the level of the key policy rate reflects banking sector expectations of further monetary easing. The October cut in the key policy rate, however, did not fully feed through into

[2] Dinar liquidity of banks is approximated as the ratio of bank liquidity (excess reserves, stock of NBS securities with banks and receivables in respect of purchased T-bills due for payment in the current month) and transaction deposits with banks. .

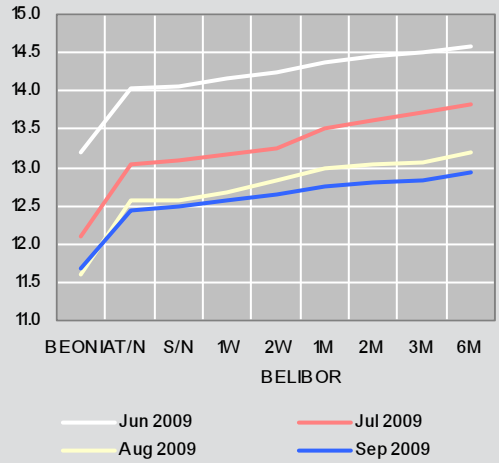
Chart III.1.2 **Interest rate movements in 2009**
(daily data, p.a, in %)



Source: National Bank of Serbia and Reuters.

Owing to high bank liquidity, shorter-maturity BEONIA and BELIBOR interest rates declined to a greater extent than the key policy rate.

Chart III.1.3 **Interbank money market yield curve**
(monthly average, p.a, in %)



Source: National Bank of Serbia and Reuters.

The yield curve on BELIBOR declined, but its slope increased. Owing to high bank liquidity, BEONIA headed down.

lower effective interest rates on treasury bills of all maturities, which is partly attributable to a certain decrease in bank dinar liquidity.

In the third quarter BEONIA moved slightly below the key policy rate (11.9% v. 12.1%). Amid ample bank liquidity, BEONIA plunged to its lowest level relative to the key policy rate (40 basis points) in August. As bank dinar liquidity decreased mildly in Septemb er and October, BEONIA trended closer to the key policy rate level.

Banking sector liquidity running high, there was no major need for overnight loans, which reflected on a decrease in the money market trading volumes by 15.7% from a quarter earlier to the last year's average of RSD 6.6 billion.

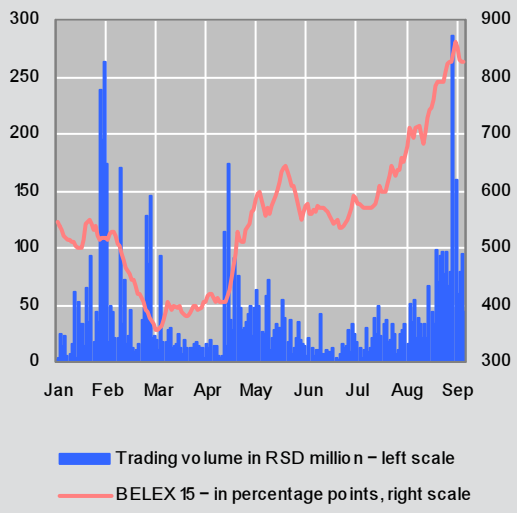
BELIBOR rates for all maturities declined with the July trimming of the key policy rate. The trend continued over the following two months but not to the quite same degree. The largest drop relative to the previous quarter was recorded for two-week maturity (2.44%) and the smallest for six-month maturity (2.24%) - BELIBOR's longest maturity. As a result, the slope of BELIBOR yield curve increased mildly.

Belgrade Stock Exchange

Q3 saw a rapid rebound in the stock exchange indices.

Belex15 and Belex line rallied 45.1% and 32%, respectively, posting the biggest gains in the region. Notwithstanding the BSE indices, the strongest rise was recorded for the indices of the most liquid shares traded on the Bulgarian Stock Exchange – Sofia (34.6%) and the Montenegro Stock Exchange (29%), and the lowest for SBI20 of the Ljubljana Stock Exchange (0.9%). It is important to note that it was exactly the Belgrade and Sofia stock exchanges that performed worst in late 2008 and early 2009 and are now vigorously rebounding.

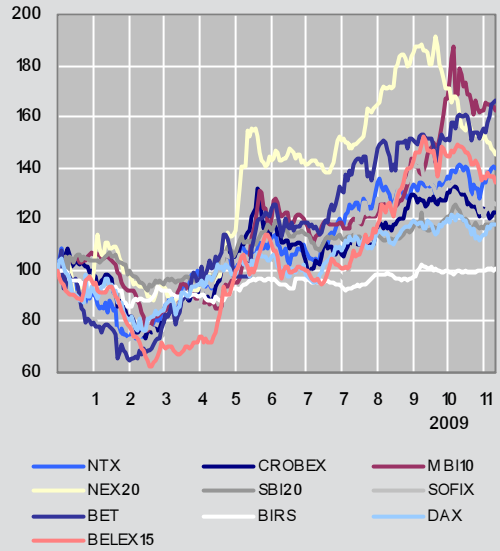
Chart III.1.4 **Belex 15 in 2009**



Source: BSE.

An increase in BELEX15 was followed by a further decline in turnover.

Chart III.1.5 **Stock exchange indices in the neighbouring countries**
(in index points, normalised, 31. 12. 2008 = 100)



Indices of regional stock exchanges continued up.

As the stock exchange indices headed up, total stock market capitalisation increased by 8.5%.

The most liquid stock indices climbed to their this year's peak primarily as a result of relatively high volume of stock trading in September (RSD 2.2 billion), which, although the highest in 2009, is still much below any of the monthly trading volumes registered last year. High trading volume recorded in September was largely driven (9.5%) by the purchase of shares of one domestic bank by foreign investors within one day only. This is indicative of extremely low liquidity of the stock market, which allows significant volatility in stock prices even when the trading volumes are relatively modest.

The 18% decrease in turnover relative to the previous quarter stems from the relatively high vol ume of block trading recorded in Q2. On the other hand, the number of executed transactions negligibly declined (0.7%), which is why, from the aspect of market breadth, there can be no talk of any major decrease in liquidity Q3-over-Q2.

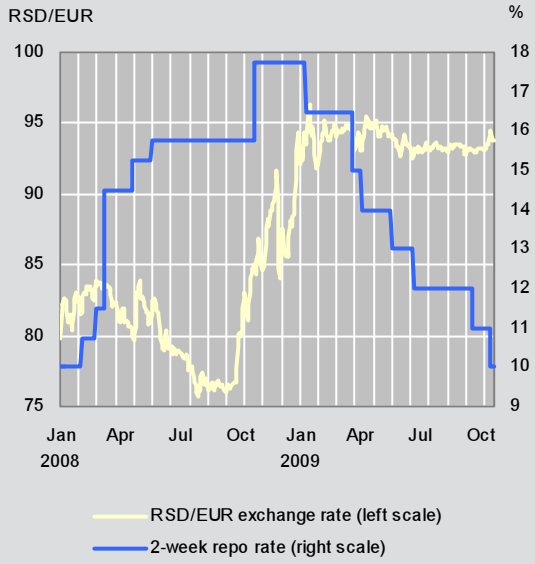
Net purchase of stocks by foreign investors amounted to around RSD 213 million, 41.1% less than in Q2. Despite positive expectations regarding price movements on the BSE derived from the Belex Sentiment index, both BSE indices retreated mildly in October. This only shows that making any forecasts about movements on the BSE is a thankless task as these movements are connected with market expectations and the performance of both the domestic and global economy.

Exchange rate

Reflecting comfortable foreign exchange liquidity position of banks, the exchange rate of the dinar was stable throughout Q3. IFEM trading volumes, however, remained low. There have been no NBS interventions in the interbank foreign exchange market since February.

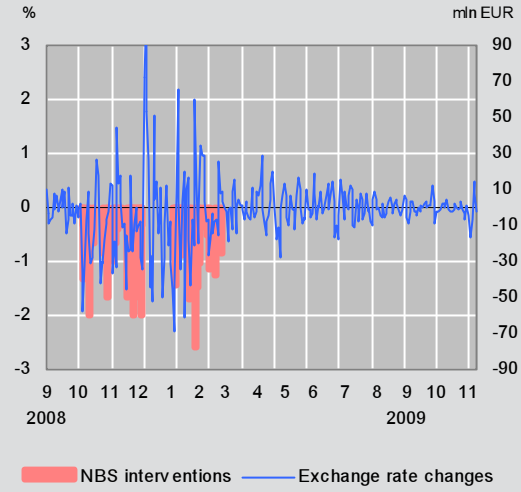
Moving within a narrow band of 92.5–93.6, the RSD/EUR exchange rate displayed marked stability in

Chart III.1.6 **Movements in RSD/EUR exchange rate and 2W repo rate**



Lowering of the key policy rate in Q3 did not cause a decline in the value of the dinar.

Chart III.1.7 **Daily changes in RSD/EUR exchange rate[1] and NBS interventions in IFEM**



[1] Negative rates indicate depreciation and positive rates appreciation of the dinar.

Daily volatility of RSD/EUR exchange rate eased as a result of stable movements in the IFEM.

Q3. Relative to a quarter earlier, the dinar rose mildly against the euro – by around 1%.

Such movements in the exchange rate can be put down to satisfactory levels of foreign exchange liquidity of banks. Namely, from July to September, banks borrowed abroad EUR 780 million (mainly short-term) and purchased sizeable amounts of foreign exchange from exchange dealers (around EUR 710 million). Household foreign currency savings rose by EUR 260 million and client demand for foreign exchange remained broadly unchanged from Q2. All of the above helped the exchange rate of the dinar withstand pressures stemming from the July lowering of the key policy rate (1 pp) and the percentage share of foreign currency required reserves to be allocated in dinars. Appreciation of both the dinar against the euro and the euro against the dollar led to the strengthening of the domestic currency vis-à-vis the dollar by 5.9% in Q3.

As a result of stronger nominal effective dinar exchange rate (by 1.2% end-of-period) and a faster rise in domestic relative to foreign prices, Q3 saw a 0.8% real effective appreciation of the dinar (0.2% against the euro and 3.3% against the dollar).

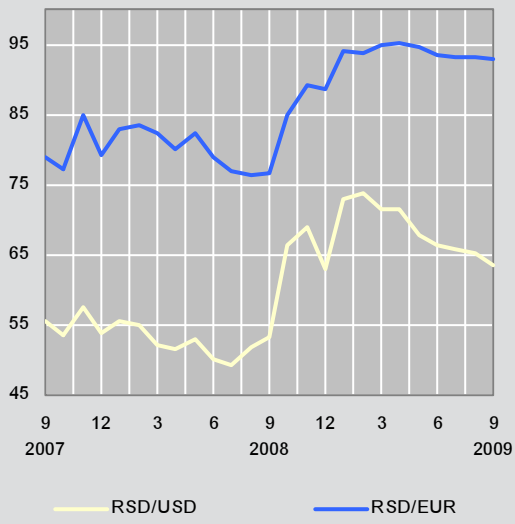
Table III.1.1 **Composition of IFEM trading**
(total trade)

	II	III	Total 2009
			(in EUR mln)
IFEM	1,965.3	1,654.0	5,714.6
NBS - Banks	0	0	556.4
Bank - bank	1,965.3	1,654.0	5,158.2
			(in % of total trade)
IFEM	100.00	100.00	100.00
NBS - Banks	0.00	0.00	9.74
Bank - bank	100.00	100.00	90.26

In Q3 the NBS did not participate in IFEM trading.

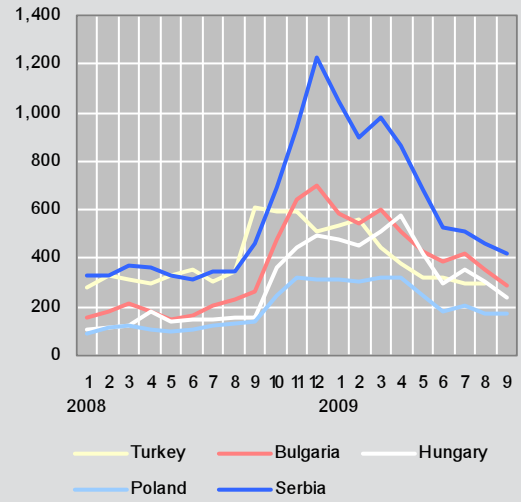
IFEM trading volumes dipped further in Q3. The average daily volume of trading equalled EUR 25 million. As in a

Chart III.1.8 **Nominal exchange rate of the dinar**
(in dinars, end of period)



In Q3, the dinar rose mildly against the euro, and somewhat more against the US dollar.

Chart III.1.9 **Risk premium indicator - EMBI**
(monthly averages, in basis points)



Source: *JP Morgan.*

All countries observed saw a decline in their risk premium in Q3.

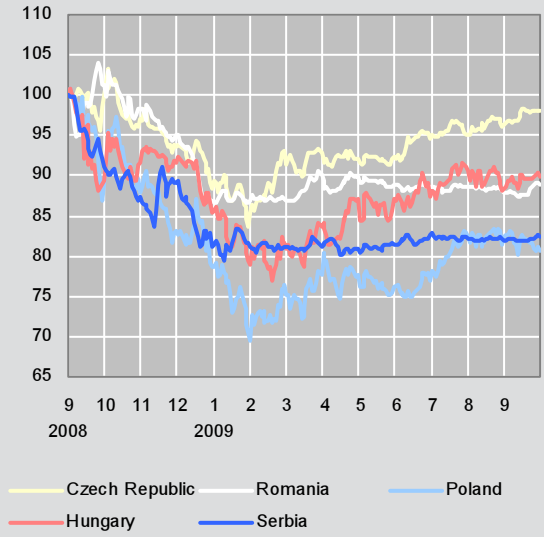
quarter earlier, with no major mismatch between foreign exchang e supply and demand, banks showed no interest in NBS foreign exchange swap auctions introduced in May as an additional measure of support to the country's financial stability.

Risk premium, measured by EMBI, continued down, but at a slower pace than in Q2 (Chart III.1.9.). From end-June, EMBI declined from around 510 to around 380 index points, which points to improved investor mood and contributes to the easing of depreciation pressures on the domestic currency.

Stable movements in the RSD/EUR exchange rate continued in October, but the average daily volume of interbank trading (around EUR 20 million) was slightly lower than a month earlier.

The October survey carried out by the Strategic Marketing Research Agency indicates that all sectors expect a lower degree of depreciation of the dinar over the next one-year period compared to the survey carried out by end-Q2. Thus, the financial and the corporate sector expect the dinar to depreciate by 5.1% and 5.8%, respectively versus 6.3% a nd 9.4% reported in the previous survey. According to the October survey carried out by Reuters, the dinar could weaken until year-end by 1.3% to around 94.5 RSD/EUR.

Chart III.1.10 **Movements in exchange rates of national currencies against the euro**
(Sep 30, 2008 = 100)



The national currencies of Romania and Serbia were stable, while the currencies of other countries mildly strengthened.

The currencies of other transition countries were also relatively stable in the course of Q3. As a result, their respective risk premiums measured by EMBI recorded a mild decline.

2. Import prices

Imported inflation continued down is most likely to remain low given the stabilisation of the exchange rate. The main impact to the upside may come from rising world oil prices.

Based on July and August data, imported inflation is estimated to have declined further in Q3, reaching around –13.7% y-o-y.[3] The average decline in USD import prices came to 30%, while the dinar weakened by 23.4% against the dollar.

Observed by SITC[4], imported prices declined in all sectors apart from the sectors of food, livestock and finished goods, while the sharpest drop was seen with mineral fuels and lubricants, raw materials (except for fuel), vegetable oil and animal and vegetable fats. Ural RCMB prices, serving as benchmark for the calculation of petroleum product prices in Serbia, rose from Q2, but remained on the downward slope in y-o-y terms.

It is important to note that import prices recorded a y-o-y decline regardless of the degree of value added of products concerned.

An estimate of imported inflation based on movements in the nominal effective exchange rate of the dinar and import prices points to a further quarterly decline (to –9.1% p.a.[5]), occasioned by the nominal appreciation of the dinar (8.6% p.a.)[6] and falling prices in the EU and USA (0.5% p.a. on average)[7] over the same period.

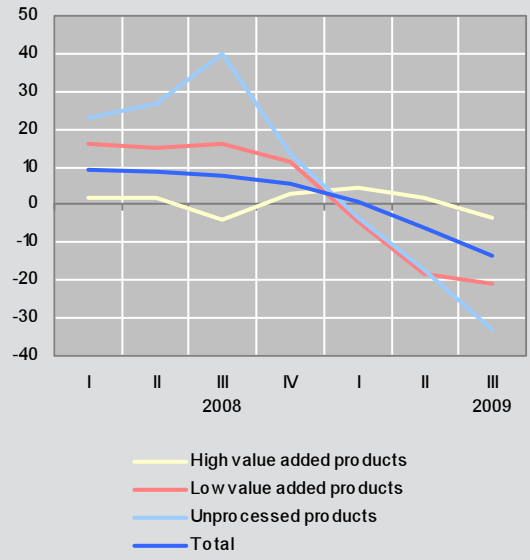
Given the stabilisation of the exchange rate, imported inflation is likely to remain low in the near future. The main impact to the upside may come from rising world oil prices.

Oil and commodity prices

Following a marked increase in the second quarter, in Q3 oil prices stabilised between USD 60 and USD 75 pb (Ural oil).

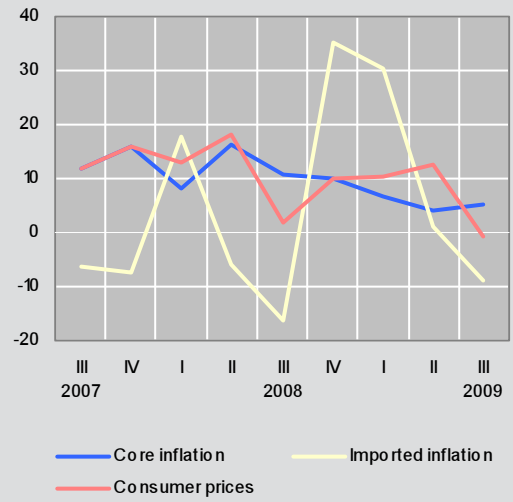
The very start of Q3 saw a precipitous drop in oil prices, from USD 70 to USD 60 pb, as a result of investors' expectations of a neither easy nor fast global economic

Chart III.2.1 **Y-o-y growth in product import prices by the degree of value added**
(in %)



In terms of the degree of value added, the prices of all products went down.

Chart III.2.2 **Core and imported inflation**
(average annualized quarterly growth rates)



Source: NBS and Eurostat.

Imported inflation continued down from Q2.

[3] Imported inflation estimate was based on the index of average import prices at the current USD exchange rate. The unit value index was adjusted by the change in the exchange rate during the period under review.

[4] Standard International Trade Classification.

[5] Annualised ratio of averages for two consecutive quarters.

[6] EUR 80%, USD 20%.

[7] Weighted average inflation figures for the EU and USA (80:20) are used in the calculation of world inflation.

recovery. After data on significantly lower than expected US oil inventories were published, prices rebounded, hitting in early August their 2009-high of nearly USD 75 pb. The prices hovered above USD 70 throughout August, stabilising in September between USD 65 (beginning and end of month) and USD 70 pb (mid-month).

The latest forecast of the IMF and official views about the global recession ending and prospects of recovery suggest that oil prices are not likely to experience any sudden fluctuations in the near future. They could, however, trend upwards, but this will depend on the speed of the global economic recovery. Such a trend may also be sustained by the weakening of the greenback, as well as by potential further cuts in OPEC members' output quotas.

Our projection of oil prices at end-Q3 stated in the last *Inflation Report* fell slightly short of the actual outcome. Considering the foreseeably higher oil demand amid the global economic recovery, and a possible further slide in the value of the dollar, we expect year-end oil prices to settle between USD 75 and 80 pb.

The price of traditional safe haven has risen, crossing in late Q3 the psychological barrier of USD 1,000 per troy ounce. The growth in gold prices was sparked by the weakening of the dollar and investor fear of an inflation rise on the back of more expansive monetary and fiscal policies implemented in developed economies.

Prices of non-ferrous metals also hiked. Copper, for instance, gained around 22% relative to end-Q2, reaching USD 6,155 per tonne on the London Metal Exchange. Stronger demand for copper and other non-ferrous metals can be put down to China's speedy economic recovery (the world's largest importer of these commodities) and to the weakening of the dollar. At the same time, aluminium rose by around 17% to USD 1,890 per tonne.

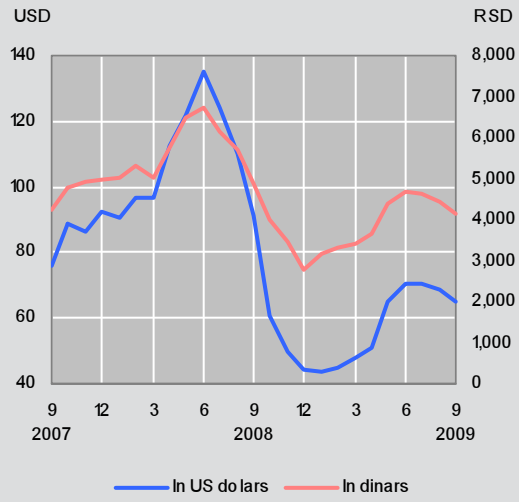
3. Balance of payments

Dampened domestic demand (final and investment consumption) induced a contraction in international economic flows and brought the current account deficit to record levels. Such trends, along with a high inflow from remittances and bank short-term external borrowing, contributed to stabilisation in the foreign exchange market.

Current account

In Q3, current account deficit totalled EUR 272.7 million – its share in GDP declined to mere 3.4%. Such a turnaround was mainly due to the narrowing of foreign trade deficit to 13.5% of GDP, occasioned by the steeper fall in goods and services imports than that in exports.

Chart III.2.3 **Ural oil prices**



Source: Bloomberg.

Despite a mild downward tendency, oil prices were relatively stable in Q3. Owing to the stable dinar, the two curves point to similar movements.

Table III.3.1 **Balance of payments in % of GDP**

	Q1 2008	Q1 2009	Q2 2008	Q2 2009	Q3 2008	Q3 2009
Current account	-17.5	-12.3	-21.7	-2.4	-15.9	-3.4
Balance of goods and services	-24.3	-20.2	-24.7	-14.2	-21.5	-13.5
Income	-1.9	-1.9	-3.7	-1.3	-1.4	-1.6
Current transfers	8.6	9.8	6.8	13.1	7.0	11.7
Capital account	0.1	0.0	0.1	0.0	0.0	0.0
Financial account (excluding changes in foreign exchange reserves)	19.4	8.7	17.6	4.1	18.4	7.4
Direct investment, net	11.4	9.7	7.9	3.4	1.4	1.4
Portfolio investment, net	-0.7	-0.1	-0.5	-0.8	0.3	0.1
Commercial credits, net	1.1	1.3	-1.0	0.3	-1.7	2.3
Financial credits, net	3.0	-10.9	11.1	9.2	14.9	7.7
Currency and deposits, net	0.8	2.3	-1.2	1.6	1.5	-0.5
Other	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions, net	-1.5	0.0	0.3	-0.4	0.4	-0.4
Overall balance	0.4	-3.6	-3.7	11.9	3.0	8.9

* Financial account excluding changes in foreign exchange reserves, SDR allocation and IMF loan.

Current account deficit shrank to 3.4% of GDP in Q3.

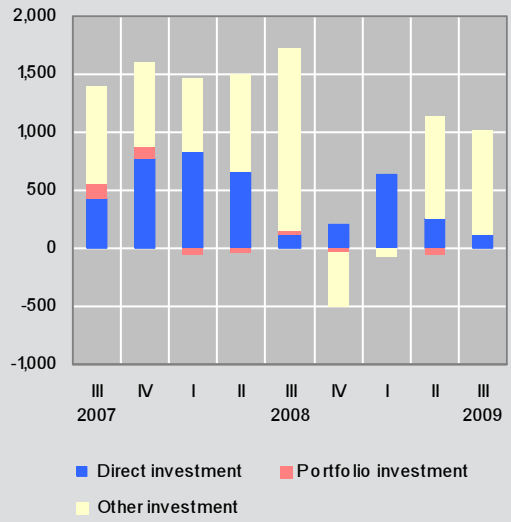
Furthermore, the deficit on trade in goods and services equalled around EUR 1,087 – down to 13.4% of GDP. Monthly imports and exports displayed different dynamics – unlike July and August that saw deterioration in foreign trade (a fall in exports and a negligible decline in imports), September witnessed a 5.2% growth in exports, while imports went further down. In terms of economic destination, all export and import items headed down, the steepest fall recorded with interm ediate goods and equipment. Q3 witnessed a discontinuation of growth in exports of almost all product groups that were on the path to recovery after March (the sharpest drop was observed with exports of grains and maize). Still, a pick-up in iron and steel exports has been in place since July owing to the tem porary restoration of producti on in the Smederevo iron plant.

Declining imports in Q3 were prompted by falling domestic demand (final and investment consumption) and low economic activity. In terms of SITC, the dominant import items were energy, intermediate and capital goods that contracted most sharply in the year to September on the back of the economic downturn and lower world prices of raw materials.

The low current account deficit was also due to the high net inflow from remittances that persisted over the entire year. Namely, Q3 saw a substantial net inflow from remittances of EUR 865.5 million. The deficit on the income side (EUR 129.2 million) remained broadly unchanged from the same period a year earlier.

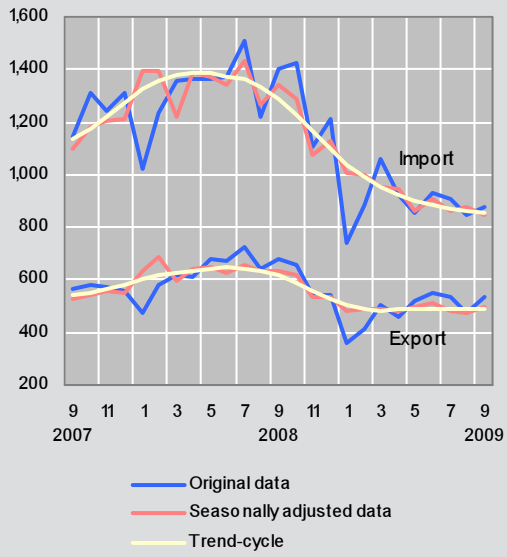
As current account deficit grew more rapidly than economic activity relative to Q2, the share of current account deficit in GDP increased from 2.4% to 3.4%.

Chart III.3.2 **Financial account structure**
(in EUR million)



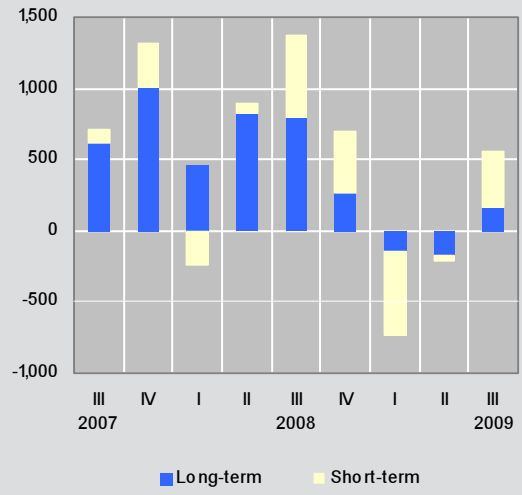
A high inflow of other investments was recorded owing to the SDR allocation in August and September.

Chart III.3.1 **Exports and imports**
(in EUR mln)



Imports exerted the strongest pressure on reduced trade in goods and services.

Chart III.3.3 **Net disbursement of financial loans**
(in EUR million)



Banks borrowed mainly short-term, while enterprises continued to repay their debt in net terms.

Capital and financial account

The surplus on the financial account was relatively high – 7.4% of GDP, as a result of the relatively substantial net inflow from financial loans (EUR 623.1 million) and SDR allocation in August and September (EUR 422.2 million). In Q3, the banking sector borrowed mainly short-term (EUR 519.5 m illion), while enterprises continued repaying their debt (EUR 243.5 million net).

At end-Q3, **NBS foreign exchange reserves** stood at EUR 9,523.4 million, up by 7.2% from Q2. If needed, the NBS could comfortably intervene in the foreign exchange market as its foreign exchange reserves are rather high. They provide for a 8.6 month coverage of goods and services imports.

The strongest inflow into foreign exchange reserves came from the IMF's SDR allocation (3.9 pp) and an increase in banks' foreign exchange required reserves (2.0 pp).

The outflow from foreign exchange reserves was prompted by the repayment of obligations in respect of frozen foreign currency savings and the Economic Development Loan (–0.4 pp).

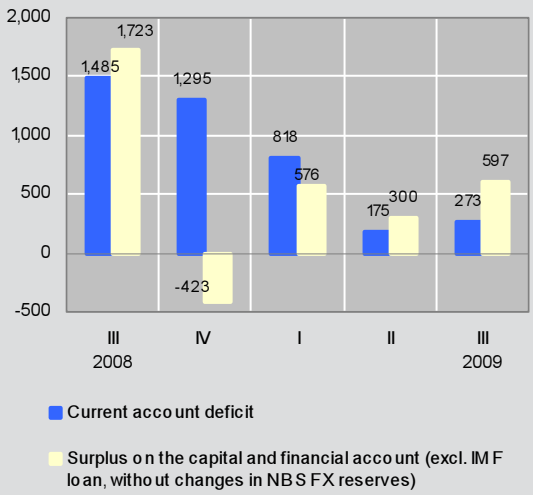
Table III.3.2 **Contribution to NBS foreign exchange reserves growth**
(in percentage points)

	2008		2009		
	Q3	Q4	Q1	Q2	Q3
NBS foreign exchange reserves (growth in %)	6.4	-15.9	-0.6	9.5	7.2
Foreign exchange market	1.6	-5.7	-7.0	1.2	0.9
Exchange transactions	0.9	1.7	0.5	0.6	0.2
NBS's foreign currency net-sale in the IFEM	0.0	-8.1	-8.1	0.0	0.0
Temporary payment transactions[1]	0.6	0.7	0.6	0.6	0.7
Reserve requirement on foreign currency deposits and credits, and new foreign currency savings deposits[2]	1.6	-11.9	-1.0	1.9	2.0
Foreign credits to government	0.0	0.2	0.2	0.2	0.7
Grants	0.2	0.2	0.1	0.2	0.2
Frozen foreign currency savings deposits[3] and Economic Development Loan	-0.5	-0.1	-0.1	-2.1	-0.4
Other[4]	3.5	1.5	7.1	8.1	3.9

[1] Payment transactions with Montenegro (until 26 June) and Kosovo and Metohija.
[2] Savings from 2003 onwards.
[3] Savings up to 2003.
[4] Income from the collection of coupons, privatisation, IMF loans, etc.

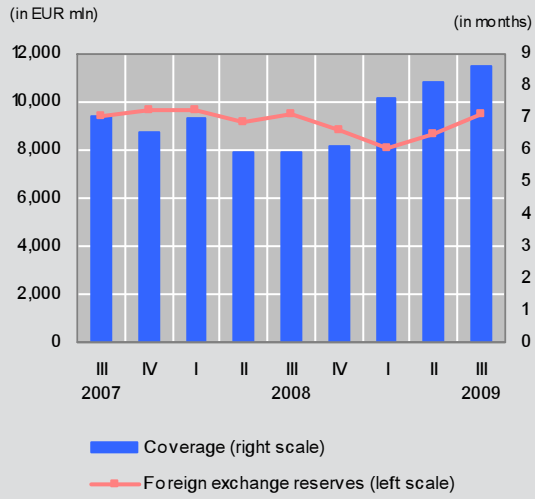
The IMF's additional SDR allocation provided the strongest contribution to foreign exchange reserves growth.

Chart III.3.4 **Current account deficit and net capital inflow**
(in EUR million)



Contracted foreign trade deficit and a high inflow of remittances impacted on low current account deficit in Q3.

Chart III.3.5 **Coverage of imports by foreign exchange reserves***



* Quarterly data.

The coverage of imports by foreign exchange reserves rose owing to an increase in foreign exchange reserves.

Projection of the balance of payments for 2009

The current account deficit is estimated to reach around EUR 2.2 billion in 2009, which is slightly more than projected in August. As the official statistics on GDP decrease in the first half of the year were revised, we adjusted the GDP projection for 2009 as well and assumed a lower GDP drop (2.8%). In accordance with that, the share of the current account deficit in GDP is somewhat higher (7.2%).

Low current account deficit is primarily a result of the low trade deficit anticipated to reach EUR 4.5 billion until year-end. The current projection assumes a fall in exports and imports of 18.1% and 29.2%, respectively. The record low level of the current account deficit is also underpinned by the high inflow of remittances estimated at EUR 3.3 billion for the year as a whole.

The projection of the financial account of the balance of payments is based on the assumption of a positive outcome of negotiations with the IMF. In other words, in addition to the first tranche worth EUR 782 million and drawn in May, the projection assumes another two tranches in the total amount of EUR 1.5 billion planned to be drawn until year-end. This included, total long-term borrowing of all sectors will reach around EUR 5 billion. An important part of the projection is also foreign exchange inflow under the August and September allocations of special drawing rights.

Projection of the balance of payments for 2009

	in EUR bln	in % of GDP
CURRENT ACCOUNT	-2.2	-7.2
Balance of goods	-4.5	-14.7
Exports	6.1	19.7
Imports	-10.6	-34.4
Balance of services	-0.1	-0.5
Income	-0.7	-2.4
Current transfers	3.1	9.9
Inflows	3.3	10.7
Outflows	-0.3	-0.8
CAPITAL ACCOUNT	0.0	0.0
FINANCIAL ACCOUNT*	4.0	12.9
Direct investment, net	1.2	3.9
Portfolio investment, net	-0.1	-0.2
Other investment	2.8	9.2
SDR allocations	0.4	1.4
ERRORS AND OMISSIONS, net	0.0	0.0
OVERALL BALANCE	1.8	5.7

* Excluding changes in foreign exchange reserves.

The above movements will result in a EUR 1.8 billion increase in foreign reserves. The growth in foreign reserves will be driven primarily by the implementation of the arrangement with the IMF (EUR 2.3 billion). In view of the high level of foreign exchange liquidity of the banking sector and stable movements in the foreign exchange market, the current level of foreign reserves can be considered satisfactory. The implementation of the Stand-By Arrangement with the IMF and drawdown of the next two tranches of the loan until year-end will serve mainly as a psychological prop in lowering the risk premium, improving the country's credit rating, and easing the depreciation pressures in the foreign exchange market.

Economic activity is expected to recover mildly and grow by 1.5% in 2010, which will lead to an increase in imports and a somewhat higher current account deficit.

Risks of growing protectionism

Since the outbreak of the global financial crisis, the sharp contraction in world trade has been one of the key factors propagating the economic downturn across the borders. The deepening of the crisis brought about a protectionist juggernaut. The text below outlines the latest protectionist tendencies and their adverse implications for competitiveness and economic growth.

Gauging the full extent of recent protectionist initiatives is far from easy. The relevant statistics become available with considerable delay and many forms of non-tarrif barriers are difficult to identify and quantify. Hence, the assessment of protectionist trends needs to rely on indirect evidence. Econometric analysis by the World Trade Organisation suggests that the frequency of anti-dumping actions, countervailing duties and safeguard measures is linked with the business cycle, with some statistical evidence of an increase in global anti-dumping activity during economic downturns. The Global Trade Alert[1] has identified 87 measures – proposed or implemented by 52 countries in the period November 2008–September 2009 – that discriminate against foreign commercial parties. By contrast, only three measures geared at trade expansion i.e. liberalisation, were implemented in the same period.

The most prominent protectionist tendencies have been associated with massive interventions in the form of government stimulus packages, which recurrently feature provisions that effectively favour domestic parties and harm foreign exporters, investors and workers. Shortly after the commitment made by G20 leaders at their November 2008 summit to refrain from raising new barriers to investment or to trade in goods and services, 17 out of these 20 nations have actually announced protectionist measures.

The consequences of a rise in protectionism can be severe. To start with, increased protectionism generates a large variety of market distortions, leading to substantial meadium and lon-run costs. Subsidies to domestic industries (including direct government aid, guaranties and bailouts) artificially reduce the costs for local firms, while tariffs and anti-dumping and countervailing duties on the other hand increase the cost of imported goods and services. These measures preserve domestic production capacities only in the short-run, but obstruct an efficient re-allocation of resources, thereby implying longer-term costs in terms of production efficiency and international competitiveness. The costs are higher in the case of small and open economies or countries specialising in sectors facing tough international competition. As for the impact of protectionism on global economic growth, special attention should be given to unilateral introduction of protectionist measures by large economies. For the sake of illustration, research has shown that a unilateral 5% increase in import tariffs by a large economy may lower the world GDP growth by up to 1% over the next four years.

Serbia also succumbed to protectionist pressures. Since the start of the crisis, the government introduced a subsidised consumer loan programme for the purchase of domestic products. At the same time, Serbia unilaterally applies the Stabilisation and Association Agreement, which means that it has lowered the customs duties on some products or abolished them altogether, as well as that more than one third of customs duties are lower than those applied by the EU. By constantly lowering the customs duties, the authorities are trying to improve Serbia's ranking on the international competitiveness scale.

The risk of a resurgence of protectionism in the aftermath of the financial crisis should not be neglected. Even though the worst-case scenario in the form of economic depression has been avoided, we should bear in mind that a sluggish global economic recovery and rising unemployment may increasingly tempt governments to adopt restrictive trade policy measures, which could lead to a retaliatory spiral of ever harsher trade restrictions. A resurgence of trade protectionism would not only significantly impair the global recovery process by further hampering trade flows and global demand, but would also reduce the global growth potential in the long run.

[1] Independent research institutes monitoring protectionist state measures implemented during the crisis period.

4. Monetary developments

Q3 was marked by growing money supply and a mild pick-up in lending activity. Enterprises continued repaying their foreign debt. Even though its recovery is likely, lending activity will generate further disinflationary pressures.

Monetary aggregates

Albeit still relatively low compared to the pre-crisis levels, money supply went up in Q3. Relative to end-Q2, M3 rose by 2.5% on the back of demand deposits, as well as term dinar and foreign exchange deposits (0.9 pp each). As fears over a collapse of the banking system subsided, a major portion of previously withdrawn deposits was returned to the system.

In real y-o-y terms, money supply was on the rise. Total funds of non-banking sectors (M3) were up by 3.1%, M2 rose 4.7%, while M1 growth remained negative, albeit to a lower degree compared to previous quarters. A similar tendency was noted with standardised growth rates (showing standard deviations from average growth rates).

The strongest impetus to M3 creation came from bank corporate lending (2 pp) and the Government's spending of deposits and sale of T-bills (2.6 pp).

Despite pronounced illiquidity of the corporate sector, dinar corporate deposits in banks went up. Even though interest rates on long-term corporate deposits rose 2 pp and those on short-term deposits declined 0.5 pp from June, the economy strove to obtain more liquidity (demand savings). The greater need for more liquid funds was prompted by a decline in inventories, lower expected production in the coming period, as well as uncertainties relating to the economic crisis.

Foreign exchange savings were on a moderate rise relative to Q2 (EUR 143 million vs. EUR 345 million). Foreign exchange corporate savings declined in nominal terms, which was offset by growing dinar deposits, whereas household dinar savings continued up. Household savings rose by EUR 263 million – July saw a EUR 123 million increase, while August and September recorded moderate growth (c. EUR 70 million each). The leve l of dinar savings remained almost unchanged.

In contrast to money supply, reserve money fell by 9.9% in real terms, replicating the fall recorded in Q2. Reserve money was withdrawn through the dinar channel – investment in repo securities (c. EUR 43 bi llion). The decline was compensated to a certain degree by the foreign exchange channel (partly due to the disbursement of World Bank and EIB loans) and the withdrawal of Government dinar deposits.

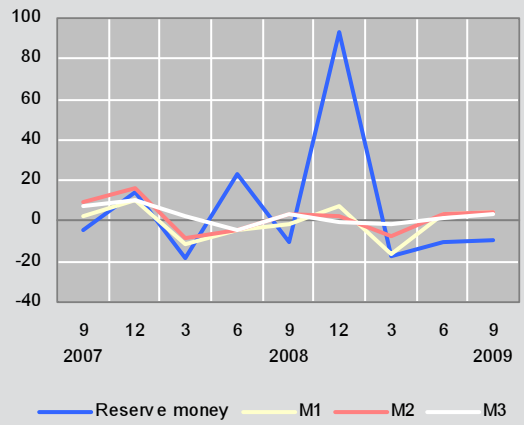
In terms of reserve money composition, the greatest change was recorded for the share of calculated required reserves (due to modified allocation structure), while the share of other categories remained practically the same.

As liquidity of the banking sector was generally adequate, banks did not use much the liquidity loans envisaged under financial stability support measures.

Table III.4.1 **Growth rates of monetary aggregates** (in percent)

	2008		2009			Share in M3 (Sep)
	III	IV	I	II	III	
M3	4.0	0.8	2.3	4.6	2.4	100.0
Foreign currency deposits	4.1	-1.3	6.7	3.7	1.5	61.7
M2	3.9	4.0	-4.4	6.1	4.0	38.4
Dinar time deposits	12.6	-2.4	8.8	6.0	4.5	17.1
M1	-1.6	8.6	-12.8	6.2	3.6	21.3
Demand deposits	-3.6	0.4	-12.5	7.7	4.4	13.6
Currency in circulation	3.0	25.9	-13.3	3.6	2.2	7.6

Chart III.4.1 **Movements in monetary aggregates deflated by consumer prices** (quaterly grow th rates, in %)



Demand for money was somewhat higher than in Q2.

Bank lending

Bank lending picked up somewhat in Q3. In real quarterly terms, lending to businesses rose 3.8% and that to households 2%.

Y-o-y lending activity slowed further, mainly in response to low demand and tighter access to loans for some economic entities. The slowdown was still sharper within the household sector both owing to deteriorated conditions in labour and real estate markets and stricter criteria for approval of new loans.

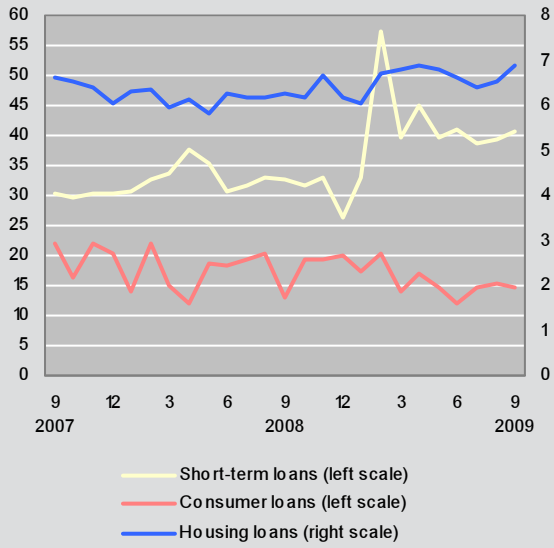
Lending activity was financed mainly from the increase in dinar corporate and household deposits (1.5 pp), and to a lesser extent through foreign excha nge savings and bank external borrowing. The funds that the Government obtained by selling T-bills ended up on corporate and household bank accounts, which impacted on lending activity being financed chiefly through the dinar channel. Although bank external borrowing was higher than in Q2, lending activity improved only mildly as banks used the major portion of these funds to allocate foreign exchange required reserves (the share of FX required reserves allocated in foreign exchange was raised).

Lending to enterprises rose by RSD 21.2 billion, mainly on account of the public company "Putevi Srbije" (c. RSD 12 billion long-term). The remaining corporate loans were mainly short-term and approved for the purposes of liquidity maintenance and purchase of current assets.

Enterprises continued repaying their foreign debt – in the past three months they borrowed around EUR 503 million and repaid EUR 746 million, while at the same time shifting to domestic sources of finance. Cross-border borrowing declined further from Q2.

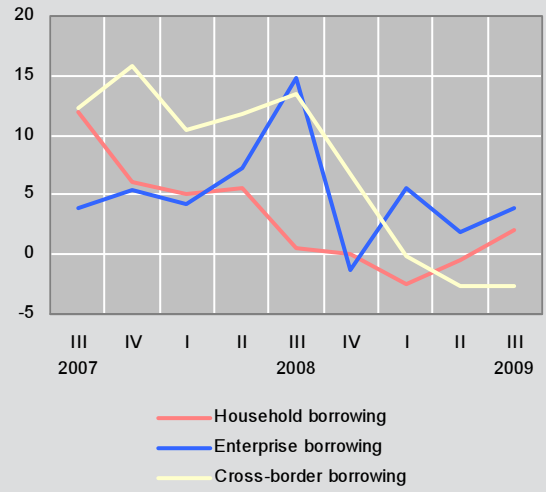
The nominal decline in household loans registered in May and June was reversed, resulting in an increase of RSD 5.8 billion. Within the composition of household loans, the sharpest increase was registered with consumer and housing loans (RSD 3 billion for each category), while receivables on cash loans, credit cards and current account overdrafts went down, pointing to low household demand.

Chart III.4.2 **Household dinar lending interest rates**
(in %)



Due to the lower share of loans under the Government Programme, interest rates on some loans went up.

Chart III.4.3 **Real domestic and cross-border borrowing**
quaterly growth rate (in %)



Corporate and household loans were on a real quarterly rise. Enterprises continued repaying their foreign debt.

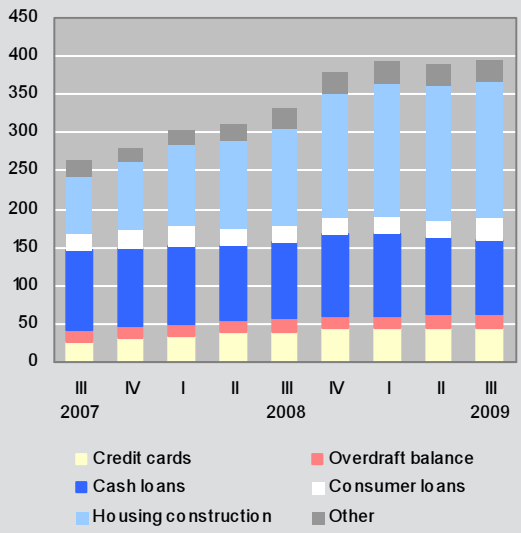
Lending activity contracted on the subsidised segment of the market.[8] In September, mere EUR 80.2 million were approved, almost twice less than in July, which can be correlated with generally meagre demand for investment loans and the fact that liquidity loans (used for refinancing purposes) were disbursed almost entirely.

The volume of approved loans on the subsidised segment of the credit market reflected on the level of the weighted average interest rate on corporate and household loans. Namely, the subsidised part of interest is not shown statistically (interest on loans approved under the Government Programme equals 3–5% p.a.), which is why the weighted average interest rate is disclosed as lower. The rate was particularly low in July (15.62% both on corporate and household loans) only to be raised to 16.7% in August when a significantly lower amount of loans was approved under the Programme. As the activity on the sub.sidised component slackened further in September, the statistical influence of such lower rates was additionally diminished, resulting in even higher weighted average lending rate both on corporate and household loans (18.86% – up by 2.4. pp from end-Q2 despite a cut in the key policy rate).

In the year to September, the share of NPLs in total loans rose by 5 pp, primarily in response to the economic downturn and growing illiquidity of the enterprise sector. However, the September rise relative to end-June was pretty negligible – it equalled 10.4%.

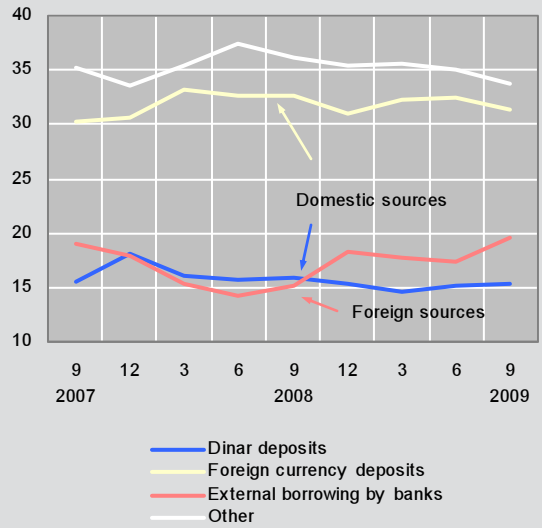
The negative real credit gap (including both enterprise and household borrowing from domestic banks and enterprise cross-border borrowing) widened further. By contrast, albeit producing disinflationary effects, the output gap points to moderate recovery of aggregate demand. As shown by previous recession episodes, a pick-up in lending activity invariably lags behind economic recovery. However, a mild improvement in lending activity is likely to be felt in the coming period as suggested by historical data on cyclical economic developments often preceding cyclical movements in lending activity.

Chart III.4.4. **Structure of loans extended to households**
(in RSD bln)



Receivables on cash loans and current account overdrafts went down.

Chart III.4.5 **Sources of bank lending growth**
(% of balance sheet total of banks)



In Q3, lending activity was increasingly financed by dinar deposits and bank external borrowing.

[8] For more detail see the text box on p. 32.

Impact of the Government Programme on lending activity

In February 2009, in response to the economic downturn and a sudden halt in corporate and household lending in late 2008, the Government adopted a set of measures[1] to bolster bank lending activity and mitigate the fallout from the global economic crisis. The Programme envisages lending to enterprises under more favourable conditions than the market ones, with enterprises required to maintain the current employment levels, as well as lending to households (aimed at stimulation of demand for domestic products) via direct interest subsidising and/or co-financing a portion of loans. The table below gives an overview of disbursement levels of different loans under the Programme.

Loans approved under the RS Government Programme
(in RSD million)

	Approved								Total	Envisaged	Realisation percentage
	March	April	May	June	July	Aug.	Sep.	Oct.			
Liquidity loans	11,239	11,405	10,034	12,411	12,144	9,050	5,670	5,701	77,655	80,000	97.1%
with currency clause	11,239	11,405	10,034	11,727	11,094	7,795	4,783	4,555	72,632		
in dinars	0	0	0	684	1,050	1,255	887	1,146	5,022		
Investment loans	0	0	49	0	58	98	0	0	204	17,000	1.2%
Household loans:	809	406	763	2,160	1,786	1,891	1,817	2,434	12,064	20,000	60.3%
- for the purchase of cars	577	171	529	1,228	1,016	932	955	1,327	6,734		
- for the purchase of tractors	0	0	41	393	205	201	109	109	1,059		
- other consumer loans	232	236	193	538	564	758	752	998	4,270		
- travel loans	0	0	0	0	0	0	0	0	1		
Total	**12,048**	**11,811**	**10,846**	**14,571**	**13,987**	**11,038**	**7,487**	**8,135**	**89,923**	**117,000**	**76.9%**

Source: Ministry of Economy and Regional Development.

An indirect aim of the Programme was the revival of investment banking, expected to contribute to swifter economic recovery. There is no disputing that the investment segment of the credit market is hit most severely by the crisis as enterprises postpone their investment and development plans for better times when the degree of uncertainty will be lower, whereas banks opt more gladly for short-term loans that imply lower risk. In line with this, not only does the Government subsidise interest, but it also participates with 30% in an investment loan, while the Development Fund grants a guarantee. However, it is only when the crisis slackens that we will be able to expect sharper investment lending, as indicated by mere 11 applications approved over the last nine months (1.2% of funds envisaged).

Liquidity loans – another model of Government's support to the corporate sector, are better tailored for the current needs of businesses. As the funds earmarked for liquidity loans were used almost to the full, the Government decided in May to double the funds initially envisaged so as to buttress the economy and widen the circle of beneficiaries.

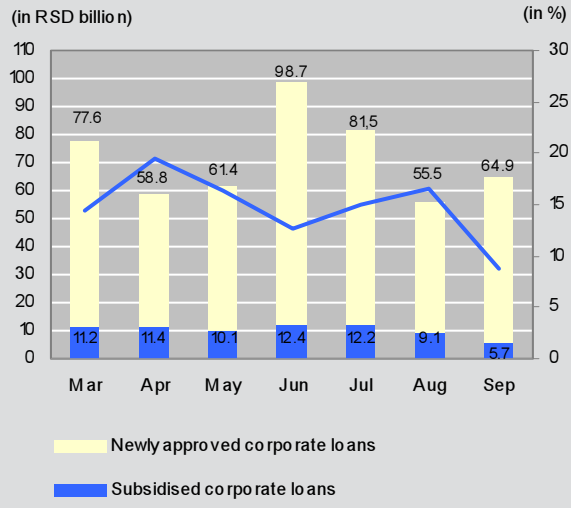
The level of the interest rate posed no major problem to economic entities in urgent need of short-term current assets. The main stumbling block were, however, banks' stricter credit-worthiness criteria, especially in view of mere 20% of economic entities being creditworthy.[2]

[1] About the package of measures please see the May Inflation Report, p. 35.
[2] According to a survey of the Serbian Chamber of Commerce, June 2009. 34.

As the Programme affects the costs of borrowing only and not the risk dispersion of lending to the "illiquid" economy (this risk being the main reason for the slowdown in credit growth), its impact on the amount of total corporate loans has been negligible.

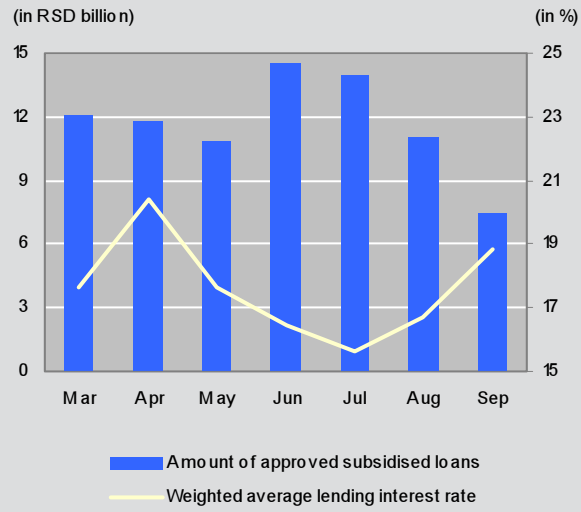
The structural weakness of the initial Programme, manifested in mandatory currency indexation of all loans, was remedied in May by the introduction of dinar liquidity loans. Despite their paltry share in total liquidity loans (6.5%), the demand for such loans has grown steadily (their September share was 16% and October share above 20%). The underlying trends should first be sought in the lowering of the key policy rate (the cost borne by the economy is mere 6.5% p.a. [3]).

Chart 1 **Newly approved corporate loans**



In spite of a mild increase in the last quarter, the disbursement of consumer loans did not yield the results expected. As loans for car purchases were the only measure living up to the Government's expectations, the Programme was lengthened further in September – until end-2009. Moreover, partial disbursement of funds shows that, despite the Government's efforts, consumer demand for domestic products is at an unsatisfactory level. The impact of subsidised household loans on bank lending activity has been inadequate. This is further substantiated by the nominal decline in household loans in May and June. It was only after the June amendments abolishing the maturity limitations on consumer loans that a mild pick-up in household lending was felt. Setting a cap on interest rates on loans covered by the Programme (3.0–4.9% on currency-clause indexed loans and 10.5% on dinar loans, with the Government subsidy of 5.0%), the Government exerted a direct influence on lowering the weighted average interest rate. However, this effect will be smaller in the period to come due to limited funds earmarked under the Programme.

Chart 2 **Approved subsidised loans and weighted average lending interest rate**



Given the total amount of budgetary funds earmarked, the positive effects of the Programme are limited to only few beneficiaries. Since the onset of the Programme, the share of subsidised loans in the newly approved ones has moved around 20%, whereas some enterprises are discouraged from participation by the Government's requirement regarding the maintenance of employment levels. Nonetheless, the demand for liquid assets by far outstrips the capacity of the state aid, leaving a number of entities unable to benefit from favourable borrowing conditions.

[3] The interest rate on dinar loans equals the NBS key policy rate + 1.5%, while the maximum interest rate is 15.5%, with the Government subsidising 5%.

5. Supply and demand

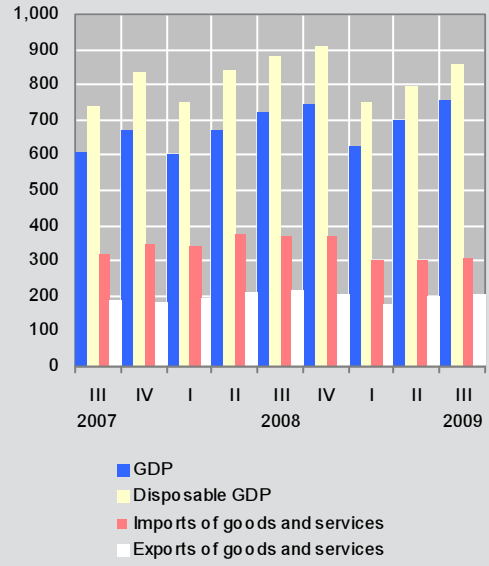
Economic activity

The economy is in recovery mode – after a fall in GDP of 4% in the previous quarter, Q3 is likely to see a more moderate decline of 2.3% y-o-y. Seasonally-adjusted quarterly data signalled a pick-up in economic activity (4.1% p.a.) for the first time in over a year. Albeit to a lower extent, output gap remained negative.

Second quarter of 2009

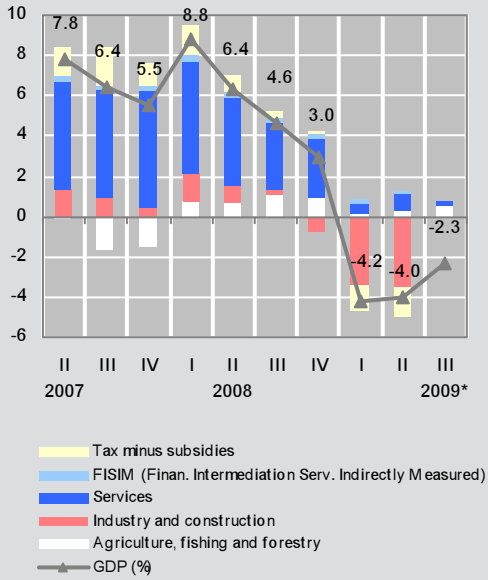
Official statistics indicate a 4% y-o-y fall in GDP, which is somewhat lower than assumed in the previous Report (4.5%). The decline in NAVA (non-agricultural value added) slowed as well (3.5% y-o-y). The same trend was also observed with quarterly GDP growth rates calculated on the basis of seasonally-adjusted data (1.6% p.a), whereas GVA (gross value added) was on the rise (2.5% p.a).

Chart III.5.2 **GDP – estimates by quarter**
(in RSD bln)



The share of exports and imports in GDP was 27.4% and 40.9%, respectively.

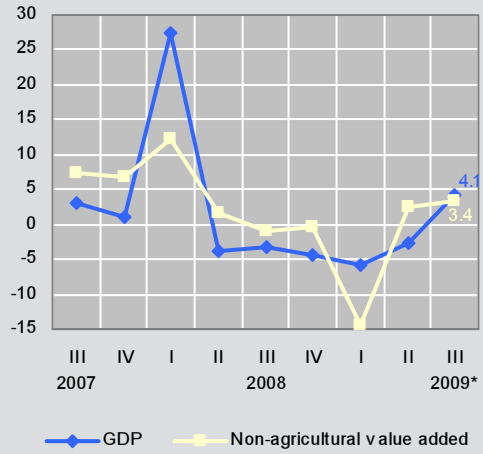
Chart III.5.1 **Contribution to y-o-y GDP growth**
(in percentage points)



* Estimate of NBS.

Y-o-y decline in GDP is expected to be slower in Q3 due to a slower decline in industrial output.

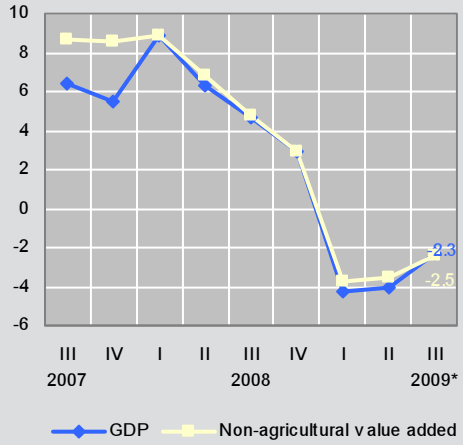
Chart III.5.3 **Growth in economic activity indicators**
(seasonally adjusted quarterly growth rates, at annual level)



* NBS estimate.

NAVA stepped up on the back of an increase in industrial output.

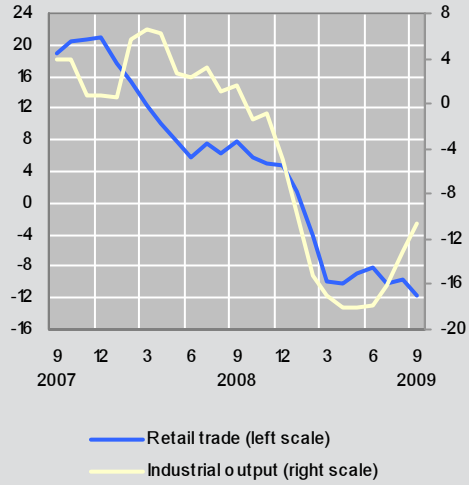
Chart III.5.4 **Growth in economic activity indicators**
(year-on-year growth rates)



* NBS estimate.

Just as GDP, NAVA recorded a slower decline in Q3.

Chart III.5.5 **Quarterly moving averages of industrial output and retail trade**
(y-o-y, in %)



Year-on-year decline in retail trade continued in Q3, while that in industrial output slackened.

Third quarter of 2009

The data available suggest a 4.1% (p.a.) growth in real GDP and moderate acceleration in GVA (3.4% p.a). Y-o-y decline is estimated at 2.3% of GDP or 2.5% of GVA.

Economic recovery is due mainly to industrial output rising by 23.7% from Q2 p.a. Following a rise in August (1.6%), industrial output increased further in September (3.1%), mainly owing to a pick-up in manufacturing. However, it should be borne in mind that industrial recovery in these two months was driven by the production of steel and iron by the Smederevo US Steel which took over the orders from US Steel's units in Slovakia that shut its facilities due to technical problems. However, the US Steel intends to idle one of its two furnaces already in December, which will reflect on a more moderate growth in industrial output.

Inventories of finished goods contracted further (6.1% y-o-y), most notably those of capital goods (17.8% y-o-y). However, in seasonally-adjusted terms, the reduction in inventories of capital goods was slower.

In line with declining production of non-metal minerals and the Government's investment consumption, the fall in construction is estimated at around 12% y-o-y.

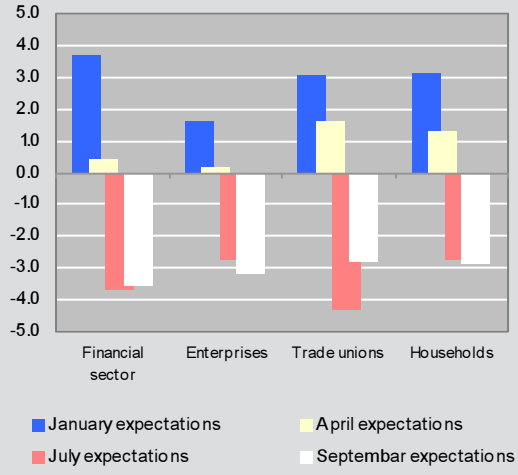
Retail trade continued down, although seasonally-adjusted data on quarterly growth rates indicate a slower decline (5.2% v. 15% p.a. in Q2).

Owing to a moderate slowdown in a GVA decline, the fall in budget revenue from customs and VAT (minus subsidies) was smaller than that in Q2.

Based on estimates of the Serbian Statistical Office on expected agricultural yield in 2009, Q3 will probably see acceleration in agricultural activity (5.2% y-o-y). The yield of all field crops, apart from sunflower, is likely to increase this year.

Albeit somewhat lower than a quarter earlier, economic activity measured by GVA is moving much below the long-term trend, which is indicative of strong demand-side disinflationary pressures.

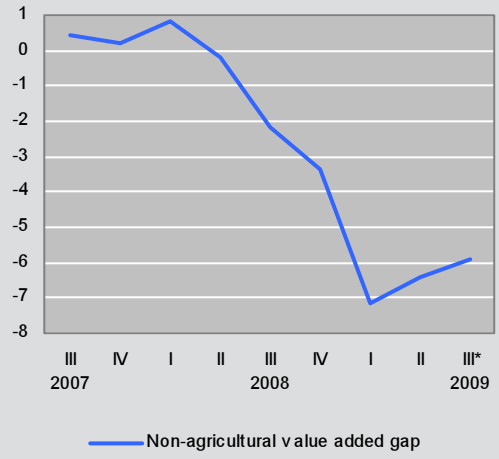
Chart III.5.6 **Expected economic growth in 2009**



Source: *Strategic Marketing Research* .

All sectors surveyed expect economic downturn and negative growth rates until the year-end.

Chart III.5.7 **Output gap**



*NBS estimate.

Even though it has narrowed down from the beginning of the year, output gap remains markedly negative.

Q4 is likely to see weaker economic growth than in Q3, resulting in a GDP fall of c. 2.8% in 2009. The strongest negative contribution will come from investment and consumption, while the contribution of net export will be positive (see the text box on page 35). The IMF forecast of real GDP growth for 2009 improved in November, equalling –3% (–4% in September).

Balance of payments data indicate that the disposable GDP could reach around RSD 855 billion (113.5% of GDP), with exports and imports of goods and services accounting for 27.4% and 40.9% of GDP respectively.

GDP distribution and estimate of aggregate demand

Official estimates of the Serbian Statistical Office of the expenditure side of GDP are available in nominal amount, with the latest figure issued for 2007. This *Report* contains our estimate of real GDP distribution in 2009 and the forecast for 2010.

The expenditure side of real GDP and data used for its estimate are shown in Table 1.

Table 1
The basic data used for estimate of GDP spending

	Data
Gross domestic product (I+II)	
I Domestic demand (1+2)	
1. Total final consumption (1.1+1.2)	
1.1 Household consumption (personal)	Statistical Office data on retail trade, transport, communications, tourism and catering; Survey of household consumption.
1.2 Government consumption	Ministry of Finance data on consolidated wage expenditure and current expenditure for the purchase of goods and services.
2. Investment spending (2.1+2.2+2.3)	
2.1 Gross investments in fixed assets	Statistical Office data on the value of completed and envisaged construction work, working hours on construction sites and capital goods imports.
2.2 Changes in inventories	Statistical Office data on inventories of finished goods in industry.
2.3 Government investment	Ministry of Finance data on capital expenditure.
II Net exports (1-2)	
1. Exports of goods and services	NBS data on RS balance of payments.
2. Imports of goods and services	NBS data on RS balance of payments.

Estimate of GDP distribution in 2009

High GDP growth rates over the previous years were driven by rising domestic demand, especially total final consumption. Stronger growth in domestic demand (mainly personal consumption) than that in economic activity resulted in a substantial trade deficit.

According to our estimates, GDP will fall by 2.8% in 2009, mainly on account of declining domestic demand (9.7%), total final consumption (5.7%) and investment spending (25.2%), as well as declining net exports (39.7%) whose contribution will therefore be positive (lower trade deficit). In terms of total final consumption, government consumption will have fallen more sharply than personal spending. The contraction in government consumption has been prompted by lower current expenditure for the purchase of goods and services, a freeze on public sector wages and a cut in the highest public sector wages.

Table 2
Contribution to y-o-y GDP growth

	2008	2009	2010
GDP	**5.5**	**-2.8**	**1.5**
Domestic demand	6.3	-11.9	3.0
Total final consumption	8.3	-5.5	-1.4
Investment spending	-2.0	-6.3	4.4
Net exports (exports –- imports)	-0.8	9.1	-1.5

Table 3
Real growth rates, in %

	2007	2008	2009
GDP	**6.9**	**5.5**	**-2.8**
Domestic demand	15.4	5.1	-9.7
Total final consumption	9.8	8.8	-5.7
Investment consumption	33.8	-7.1	-25.2
Net exports (exports –- imports)	47.8	3.4	-39.7

Table 4
Share in estimated GDP, in %

	2007	2008	2009
GDP	**100.0**	**100.0**	**100.0**
Domestic demand	123.3	122.9	114.2
Total final consumption	94.7	97.7	94.8
Investment spending	28.6	25.2	19.4
Net exports (exports – imports)	-23.3	-22.9	-14.2

Within domestic demand, a much sharper fall was registered with investments (25.2%) than total final consumption (5.7%). On the other hand, positive contribution of net exports stemmed from a steeper decline in imports (26.1%) than exports (16.2%).

Such movements brought about a significant change in the GDP structure – a fall in the share of domestic demand (total final and investment consumption) and a much smaller need for external sources of consumption.

Given the disinvestment trend in place throughout 2009, economic growth is highly unlikely to rebound to its pre-crisis levels in the coming years.

GDP distribution forecast for 2010

GDP growth in 2010 is expected to reach 1.5%. Economic recovery will be aided by rising investment spending (23%), spurred by the expectedly higher inflow from FDIs, greater availability of external finance for businesses, recovery in credit activity and stronger growth in the imports of capital goods. In terms of composition of investment spending, the government is expected to step up its investment activity (20%) in light of the weak execution of capital expenditure in 2009 and the projects announced for 2010.

Table 5
Contribution to y-o-y GDP growth

	2007	2008	2009
GDP	**6.9**	**5.5**	**-2.8**
Domestic demand	19.4	6.3	-11.9
Total final consumption	9.5	8.3	-5.5
Investment spending	9.9	-2.0	-6.3
Net exports (exports –- imports)	-12.5	-0.8	9.1

Moreover, final consumption will decline further by 1.5%. The freeze on public sector pensions and wages will induce a decline in government final consumption (the projected real fall of 6%). A decline in household final consumption is likely as well, but to a lesser degree than in 2009.

Given the expected economic recovery in 2010, driven mainly by growing investment activity, it is realistic to expect a somewhat wider trade deficit, i.e. a greater share of net exports in GDP. Furthermore, having in mind the projected significant improvement in investment spending, the composition of goods and services imports is likely to change as well – capital goods imports will probably outstrip the imports of consumer goods, which is consistent with our projection of total final consumption.

Table 6
Real growth rates, in %

	2008	2009	2010
GDP	**5.5**	**-2.8**	**1.5**
Domestic demand	5.1	-9.7	2.7
Total final consumption	8.8	-5.7	-1.5
Investment spending	-7.1	-25.2	23.0
Net export (imports - imports)	3.4	-39.7	10.8

Foreign demand

It became clear in Q3 2009, and especially after data on German and French GDP growth rates for Q2 relative to Q1 were published (0.3% each), that the developed economies saw the last of recession and that the global economy was heading towards a mild recovery. This was confirmed by the IMF in its half-yearly World Economic Outlook, which in addition to dispelling fears of global depression also featured a number of warnings.

The most important warning relates to the sustainability of nascent economic recovery. The WEO said this rebound was primarily a result of aggressive crisis management, i.e. strong monetary and fiscal stimulus packages enacted by central banks and governments, rather than of solid fundamentals ensuring a recovery sustainable in the medium run. Hence, it is vital that none of the stimulus measures be withdrawn too early as this could trigger yet another drop in economic activity.

To set the global economy on a path to sustainable recovery, the existing imbalances need to be corrected. These imbalances are reflected in the high trade surpluses of countries with export-driven growth (Japan, China, Germany) and same size trade deficits of countries with import-driven growth (USA). At the same time, the IMF cites weak demand in the most advanced economies (the USA, Western Europe countries and Japan) as one of the key risks derailing the recovery.

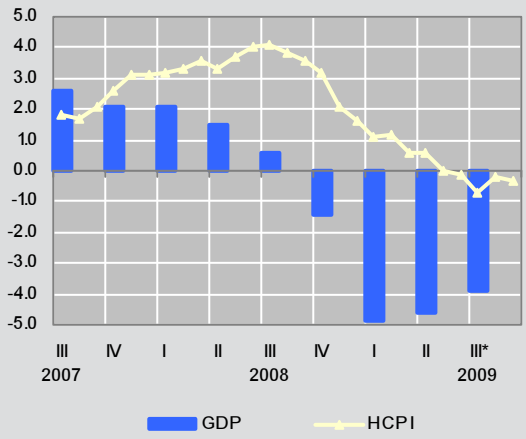
Its latest forecasts of economic growth by region and at global level for this and the next year show slightly more optimism than those released in July. The estimated decline in eurozone economic activity for 2009 was revised downwards, while 2010 growth is expected to turn positive. As for our major trading partners within the eurozone, growth prospects for Germany improved significantly, while those for Italy remained unchanged for this year and improved mildly for the next year. The October Consensus Forecasts envisage a mild economic

Table III.5.1 **Real GDP growth forecast**

	Forecast		Change from July forecast	
	2009	2010	2009	2010
World	1.1	3.1	0.3	0.6
Euro zone	-4.2	0.3	0.6	0.6
Top importers of Serbian products				
BiH	-3.0	0.5	-0.5	0.2
Germany	-5.3	0.3	0.9	0.9
Italy	-5.1	0.2	0	0.3
Montenegro	-4.0	-2.0	-1.3	0.5

Source: IMF, *World Economic Outlook, October* 2009.

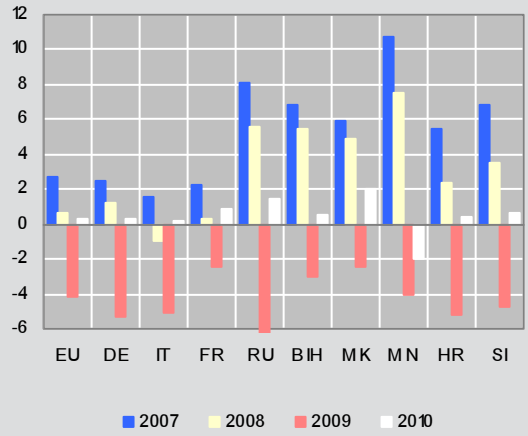
Chart III.5.8 **Euro zone GDP and inflation**
(y-o-y growth rates)



*Estimate.
Source: *EUROSTAT*.

Deflationary trends that started in Q2 continued into Q3. A fall in GDP is expected to slow down.

Chart III.5.9 **Serbia's key foreign trade partners - GDP growth rates and their projections**
(in %)



Economic activity in Serbia's key foreign trade partners is likely to contract sharply in 2009 and recover somewhat only in 2010.

rebound and positive quarterly growth rates in the EU beginning from the third quarter.

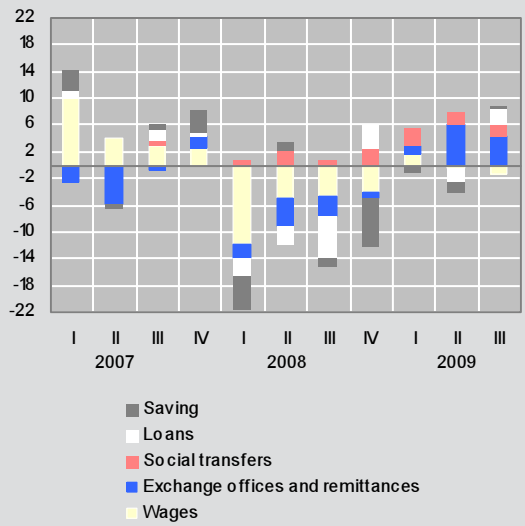
The IMF's pro jections of growth for Central and East European countries, with which Serbia trades substantially, are unchanged for the current year and much more favourable for the next year. The economic outlook for 2009 for former SFRY countries worsened, while outlook for 2010 improved compared to the July projection.

It follows from the relevant forecasts for 2009 that foreign demand declined significantly from the previous year, feeding through into sharp contraction in the volume of Serbia's foreign trade in the first nine months of the year. Although the economic decline came to a halt in Q2 and Q3 and the green shoots of recovery started to appear in our key trading partner countries, this is unlikely to lead to any major increase in foreign demand.

Indicators of consumer spending

The sources of consumer demand declined in Q3 relative to the same period a year earlier. A drop in consumer demand is also indicated by the lower retail trade turnover.

Chart III.5.10 **Structure of household consumption souces**
(quarterly changes, in percentage points)



A decrease in household income was partly compensated for by the inflow of remittances.

Falling household income against the backdrop of high illiquidity of the economy points to continued decline in the sources of consumer spending. In real terms, overall household income (wages, pensions and social transfers) fell by 1.7% relative to Q3 last year. At the same time, lending to households remained unchanged in real terms and household savings recorded a mild increase. Lower amount of funds available was partly compensated for by the significant inflow of remittances, which are estimated based on the exchange dealers' net purchase of foreign exchange from households.

Retail trade turnover slumped by 10% in Q3. Although this indicates a decline in household spending, it should be noted that there has been an increase in natural consumption and turnover in the green ma rkets, which means that households re-directed a part of their demand to these channels of supply.

Public consumption

Despite its stronger effect on aggregate demand, budget deficit narrowed from a quarter earlier. Q4 is likely to see both a higher deficit and stronger effect on aggregate demand.

The real decline in total consolidated revenue (4.0% y-o-y), grants excluded, mirrored the increase in consolidated expenditure. As a result, Q3 saw a budget deficit of RSD 30.6 billion.

Although much lower than the overall deficit, the effect of budgetary flows on demand (RSD 15.8 billion) was stronger than in Q2 as the deficit was financed less through the sale of T-bills.

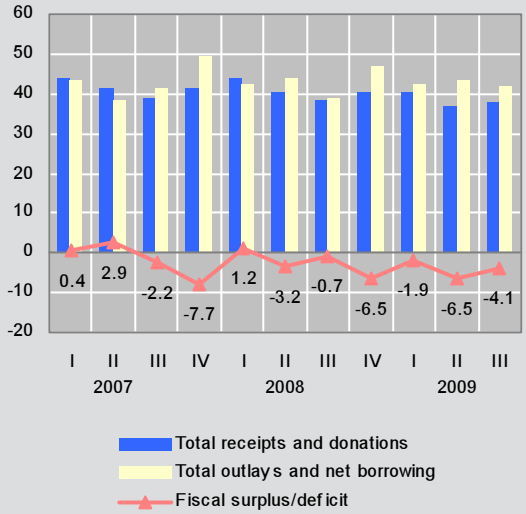
Of revenue categories, real y-o-y growth was recorded only with excises, non-tax and capital revenue, with excise growth (16.5%) being particularly strong in response to amended legal regulations. Albeit on a steep upward path, non-tax and capital revenue (11.6% and 35.0% y-o-y in real terms respectively) played a rather insignificant role in the total amount (growth in non-tax revenue came mainly from payment of public companies' profit into the budget). Due to lower imports, the sharpest y-o-y real decline originated from customs revenue (33.6%), while VAT receipts were on a more moderate decline (4.5%). Relative to the previous quarter, the revenue side of the budget remained broadly unchanged,

although total revenue rose by 11% in real terms, which confirms the thesis that the worst of the crisis, at least in terms budget revenue, is over.

On the expenditure side, the strongest real y-o-y growth was recorded with interest payments on domestic borrowing (RSD 2.5. billion), followed by payment of subsidies (24.6%) and social security outlays (7.9%), most notably pensions. However, despite the growth, the realisation of subsidies was mostly in accordance with plan. By contrast, real y-o-y decline was observed with employee salaries (3%), purchase of goods and services (0.6%) and capital expenditure (22.7%).

Assuming that the Q4 revenue maintains the trend recorded in the year to date, and the expenditure is executed according to the current budget revision (wher e possible given the costs incurred so far), the Q4 deficit is likely to outstrip that from Q3. The most realistic assessment is moderate widening of the deficit with growth recorded on both the revenue and expenditure side.

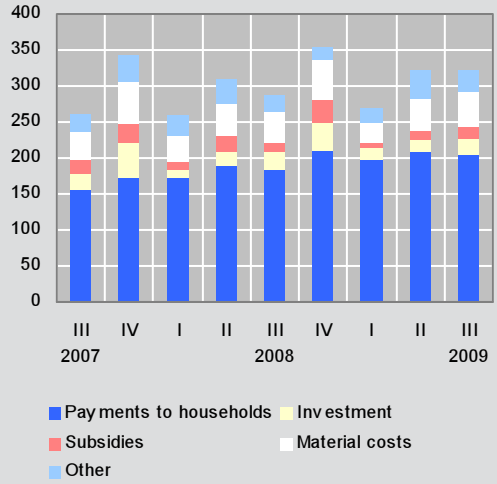
Chart III.5.11 **Public revenue and expenditures (IMF methodology)**
(as % of GDP)



Source: Recalculated based on data provided by the RS Ministry of Finance.

Consolidated fiscal deficit amounted to 6.6% of GDP, which is rather high even in crisis conditions.

Chart III.5.12 **Structure of public expenditures**
(in RSD bln)



Source: Recalculated based on data provided by the RS Ministry of Finance.

The share of investment expenditure remains low.

Table III.5.2 **Fiscal balance**
(by quarter, in RSD billion)

	2007				2008				2009			Indices	Indices, real
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q3 2009 / Q3 2008	Q3 2009 / Q3 2008
I. Consolidated revenues and grants	220.36	232.94	240.56	281.74	263.58	273.39	275.21	303.32	251.07	258.38	285.20	103.6	96.0
o/w grants	0.13	0.27	0.35	0.42	0.16	0.52	0.30	0.32	0.19	0.45	0.87	284.6	263.8
II. Consolidated expenditures and debt repayments	219.91	230.14	259.82	343.19	258.05	308.83	286.53	353.90	266.82	323.42	321.84	112.3	104.1
foreign debt repayment	1.32	0.47	2.07	0.81	1.30	2.01	2.84	1.54	3.81	3.84	3.17	111.4	103.3
frozen foreign currency savings repayment	0.59	13.19	3.75	8.94	0.50	12.71	3.56	1.20	0.42	16.44	3.72	104.5	96.8
debt pre-payment	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00		
III. Consolidated revenues without grants	220.23	232.67	240.21	281.32	263.41	272.87	274.91	303.00	250.88	257.93	284.33	103.4	95.9
IV. Consolidated expenditures (excluding foreign debt repayments, pre payments and FFCD repayments)	218.01	216.48	254.00	333.44	256.26	294.12	280.12	351.17	262.59	303.14	314.95	112.4	104.2
Fiscal balance - IMF methodology (III - IV)	2.23	16.19	-13.79	-52.13	7.15	-21.24	-5.21	-48.17	-11.72	-45.20	-30.61	587.5	544.5
GDP	503.40	565.60	616.50	677.40	603.21	673.11	721.17	746.17	624.06	697.53	753.90	104.5	96.9
Fiscal balance - IMF methodology in % of GDP	0.44	2.86	-2.24	-7.70	1.19	-3.16	-0.72	-6.46	-1.88	-6.48	-4.06	562.0	520.9

Source: Calculation based on RS Ministry of Finance data.

Table III.5.3 **Consolidated public expenditure**
(by quarter, in RSD billion)

	2007				2008				2009			Indices	Indices, real
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q2 2009 / Q2 2008	Q2 2009 / Q2 2008
Total expenditure and debt repayment[1)]	218.1	229.8	256.7	341.1	253.7	308.7	286.4	353.8	268.1	323.4	321.8	112.4	104.1
Outlays to households:	150.5	156.4	167.1	183.6	182.7	200.7	197.0	224.0	211.3	220.7	219.9	111.6	103.4
Net wages	53.1	57.5	59.4	69.7	63.9	71.3	68.6	78.9	70.1	72.8	71.7	104.6	97.0
Employee contributions	9.4	10.5	10.8	12.3	11.2	12.4	12.5	13.9	12.7	13.2	13.1	104.9	97.2
Social transfers	88.0	88.4	96.9	101.6	107.6	117.0	116.0	131.2	128.5	134.7	135.1	116.5	107.9
Pension benefits	70.2	72.0	74.6	79.4	84.8	91.7	93.8	105.6	106.0	108.9	109.9	117.1	108.5
Social benefits	15.1	13.7	19.4	18.3	19.1	20.7	17.3	20.5	18.1	21.1	19.5	112.7	104.5
Other transfers to households	2.7	2.7	2.8	3.9	3.6	4.6	4.9	5.2	4.4	4.7	5.7	117.2	108.6
Subsidies	9.5	11.8	20.0	26.5	13.3	22.2	13.9	28.3	11.0	14.7	18.7	134.4	124.6
Material expenses	27.1	32.8	36.4	56.6	34.3	43.0	42.5	56.6	26.3	44.6	45.6	107.3	99.4
Investment	17.9	15.3	22.2	50.6	10.6	21.1	24.2	40.8	14.0	17.9	20.2	83.5	77.3
Interest expenses	5.8	3.1	4.2	2.9	5.3	2.5	4.8	3.3	5.6	4.4	6.6	138.6	128.5
Debt repayment	10.9	13.8	5.8	14.2	7.0	18.2	9.2	5.4	6.2	27.8	51.4	559.4	518.4
Payments in respect of frozen f/c savings and pension arrears	9.6	13.3	3.8	13.4	5.7	12.7	3.6	1.2	0.4	16.4	3.7	104.5	96.8
Foreign debt repayment	1.3	0.5	2.1	0.8	1.3	2.0	2.8	1.5	3.8	3.8	3.2	111.4	103.3
Repayment of outstanding internal debt	1.9	0.3	3.1	1.0	4.4	3.5	2.8	2.6	2.0	7.5	44.5	1598.4	1481.4
Other[2)]	7.7	7.4	14.9	20.0	16.1	16.9	10.0	11.9	8.5	14.0	16.9	169.4	157.0

[1)] The sum does not include employee contributions and repayment of outstanding internal debt.

[2)] Item Other includes: other transfers, net purchase of financial assets and other current expenses.

Source: Calculation based on RS Ministry of Finance data.

Investment spending indicators

Nearly all indicators point to a slower decline in investment activity in Q3.

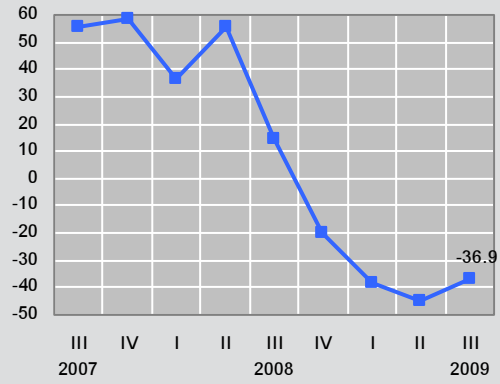
A milder decline in investment spending registered in Q3 can be taken as a sign of impending economic recovery. The decline in imports of capital goods, as the most important indicator, eased year-on-year, while the production of capital goods remained practically unchanged (22.5%). Slackening in the pace of decline recorded for investment into fixed assets resulted from a mildly recovered lending activity and an increase in corporate lending. The downturn in construction industry (estimated at 12% year-on-year) also lost some speed.

Nonetheless, investment spending remains low due to tighter access to foreign sources of financing for enterprises and an unprecedentedly low inflow of foreign direct investment.

The rise in short-term corporate lending in Q3 resulted in a milder year-on-year drop in investment into current assets. This is further confirmed by the moderated decline in not only the production of intermediate goods, but their exports and imports as well. The stocks of intermediate goods, on the other hand, recorded a much steeper year-on-year drop.

Public investment remains low. Although slightly higher than a quarter earlier, government capital expenditure shows a precipitous year-on-year drop – 22.7%.

Chart III.5.13 **Growth in imports of capital goods**
(year-on-year growth rates)



Imports of capital goods recorded a lower year-on-year decline in Q3 than in the previous two quarters.

Table III.5.4
Investment indicators
(growth rates in %)

	Q1 2008 / Q1 2007	Q2 2008 / Q2 2007	Q3 2008 / Q3 2007	Q4 2008 / Q4 2007	Q1 2009 / Q1 2008	Q2 2009 / Q2 2008	Q3 2009 / Q3 2008
Real indicators							
Physical volume of industrial production of capital goods	7.8	18.4	3.6	-7.3	-29.8	-22.3	-22.5
Physical volume of industrial production of intermediate goods	6.5	6.8	-0.2	-12.8	-34.7	-34.2	-18.8
Construction	9.2	8.1	2.5	-1.1	-13.8	-16.1	-12,0*
Imports of intermediate goods	31.2	32.4	22.1	-13.6	-39.3	-41.3	-34.6
Exports of intermediate goods	33.0	43.0	28.5	-26.6	-49.8	-53.3	-44.0
Stocks of intermediate goods	-2.4	-2.3	-1.3	-0.3	0.0	-4.2	-5.3
Imports of capital goods	36.7	50.8	19.4	-19.8	-38.1	-44.5	-36.9
Exports of capital goods	66.9	77.3	69.3	16.0	-21.2	-23.8	-30.8
Stocks of capital goods	-4.4	-5.3	-5.3	-8.7	-17.7	-20.5	-17.8
Government investment spending	-46.9	23.2	-1.5	-25.8	-21.3	-22.0	-22.7
Financial indicators	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009
Medium- and long-term external borrowing by enterprises (net) in EUR billion	627.9	870.6	775.0	379.0	-160.2	-226.0	-114.0
Short-term credits to entreprises in RSD billion	27.7	24.3	27.9	19.8	55.9	2.2	8.0
Long-term credits to households in RSD billion	22.5	3.5	6.3	45.7	12.8	-5.6	4.1
Long-term credits to enterprises in RSD billion	14.1	7.2	38.3	39.7	18.6	3.4	10.6

* NBS estimate.

Note: The loan (EUR 600 million) approved in June 2007 by Citigroup to "Telekom Srbija" (for the purchase of "Telekom" of the Republic of Srpska) is excluded from long-term enterprise borrowing as it had no influence on investment activity in the country.

6. Labour market developments

Wages

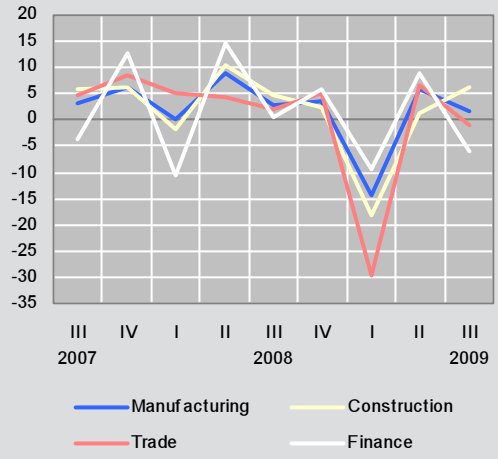
Wages rose negligibly in nominal terms, but kept their Q2 level in real terms. As there was no growth in real wages and productivity gathered pace, unit labour costs in the industrial sector declined.

A mild recovery of economic activity in Q3 was accompanied by the 1.7% nominal wage growth (seasonally-adjusted)[9]. In real terms, wages remained unchanged from the previous quarter.

The average net wage in Serbia equalled RSD 31,737 or EUR 342, which is by 1.1% higher than in Q2, primarily as a result of appreciation of the dinar against the euro.

The strongest, and seasonally-induced, nominal wage growth was registered in the construction industry. Slower nominal wage growth was recorded in the processing industry and transport, while nearly all other sectors saw a decline.

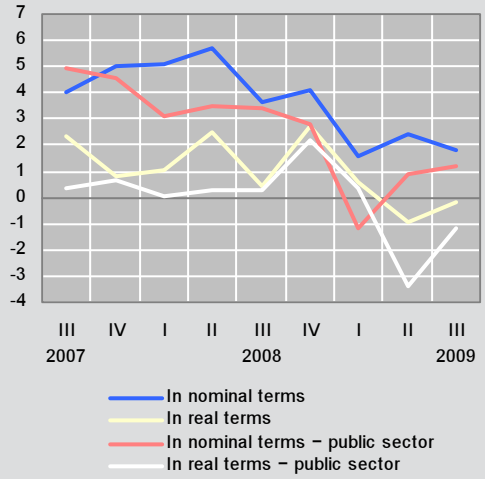
Chart III.6.2 **Movements in net average wages**
(quarterly growth, in %)



* Growth in total nominal and real wages in 2009 is calculated based on the new methodology.

Net average wages declined in all sectors save constructon, manufacturing industry and transport.

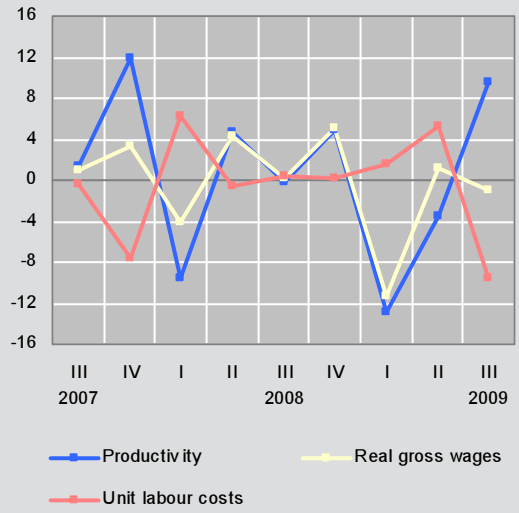
Chart III.6.1 **Movement in average net wages - total and the public sector**
(seasonally-adjusted data, quarterly growth, in %)



* Growth in total nominal and real wages in 2009 is calculated based on the new methodology.

In nominal terms, total and public sector wages recorded minimum growth, while remaining unchanged in real terms.

Chart III.6.3 **Movements in productivity, real gross wages and unit labour costs in the industry**
(quarterly growth, in %)



Unit labour costs in the industrial sector declined as a result of growth in productivity.

[9] Data for 2007 were adjusted by the effects of the early 2008 change in the wage calculation methodology.

Nominal public sector wages fell by 0.9%, while seasonally-adjusted data show marginal growth (1.2%).

The revival of industrial production in Q3, the drop in real gross wages and industrial sector employment resulted in a 9.6% decline in unit labour costs. The decline is even steeper in the processing industry, where it measures 11.5%.

Employment

A mild recovery in economic activity was accompanied by negligible growth in employment. A further decline in total employment as well as other indicators point to worsened labour market conditions.

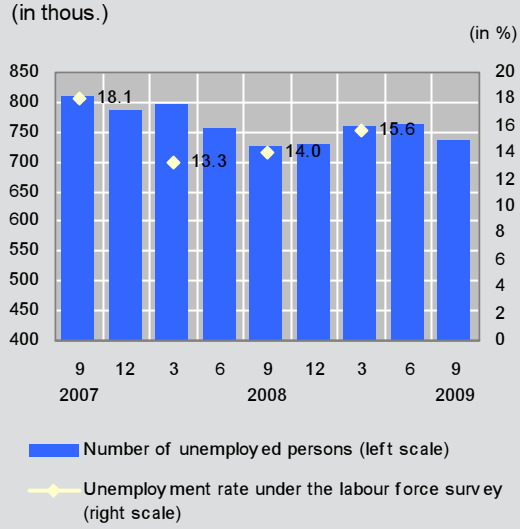
A mild recovery in economic activity did not reflect on labour market indicators. According to the labour force survey carried out by the Statistical Office, formal employment in Q3 continued down. A decline in employment was recorded with legal entities, while data on the number of employees by natural persons (entrepreneurs) are still unavailable.

Manufacturing and construction suffered the sharpest decline in jobs – by around 7,000 and 1,000 respectively. A more complete picture of total employment will be obtained once data on employment in legal entities and data from the labour force survey become available. However, there is no disputing that labour market conditions have deteriorated – the unemployment cycle often lags behind the economic cycle.

Jobs in the public sector were cut by around 4,500. The decline was also recorded with budget-financed employees, as well as those from public and local enterprises.

Data of the National Employment Service suggest a decline in unemployment by 25,900 (3.4%). Due mainly to administrative measures (deletion of non-active employees from records), such a decline is not indicative of real circumstances in the labour market.

Chart III.6.4 **Unemployment**
(in thous.)



Source: National Employment Service and Serbian Bureau of Statistics.

The drop in unemployment is attributable to administrative measures rather than to the impact of a mild pick-up in economic activity.

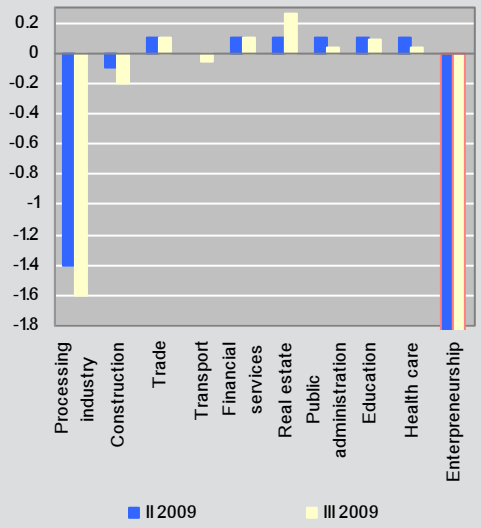
Chart III.6.5 **New employment**
(in thous.)

* NBS estimate.

Source: Statistical Office and National Employment Service.

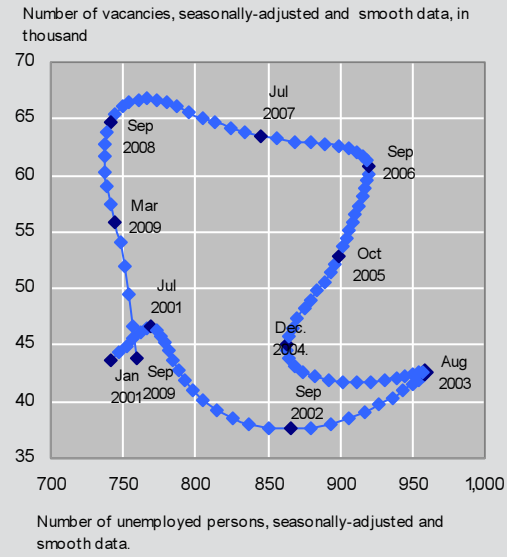
A mild recovery in economic activity was accompanied by an increase in new employment contracts.

Chart III.6.6 **Employment by sector**
(contribution to y-o-y employment growth, in pp)



The steepest drop in employment was registered in the sector of entrepreneurs.

Chart 3.6.7 **Beveridge curve**



The slope of Beveridge curve points to continued negative trends in the labour market.

The number of vacancies declined on the previous quarter, while new employment intensified. However, data on the drop in vacancies must be taken with reserve in light of amendments to the Law on Employment and Unemployment Insurance abolishing the employers' obligation to inform the National Employment Service of their employment needs. Furthermore, employment refers to total number of employment notices submitted by employers to the National Employment Service.

The worsening conditions in the labour market are also confirmed by the Beveridge curve, calculated on the basis of seasonally-adjusted data on the number of vacancies and the unemployed.

IV. Inflation projection

Inflation is most likely to move below the midpoint of the target band in the coming period, with the risk of undershooting its lower bound in the first half of 2010. Dampened aggregate demand, together with a freeze on public sector wages and pensions, will be the key factor of price stability and possible further lowering of the key policy rate.

The medium-term inflation projection aims to show expected inflation movements (CPI), the main factors behind such movements and the underlying risks. It is expressed in terms of a range and as a central projection figure. This projection presumes an active monetary policy bent on keeping inflation within the target band in the medium run and thus fulfilling its principal role as defined by the current monetary policy framework.

Background information

Q3 inflation declined, slipping further into the lower half of the target band under the impact of a significant drop in agricultural product prices, near-zero growth in regulated prices, stable exchange rate and low demand.

Another important factor was a rather weak growth in processed food prices, which largely resulted from the low prices of input materials, i.e. agricultural products.

After robust growth in H1, regulated prices were kept almost unchanged in Q3. Similar trends are expected until the end of the year, except for the prices of petroleum products.

In the medium run, low demand continues to be the key disinflationary factor. Although output gap (demand-side measure) contracted slightly in Q3, it remains markedly negative.

Inflationary pressures are also expected to subside as a result of successful completion of negotiations on the continuation of arrangement with the IMF. Namely, our government has committed to cut real current expenditure in the medium-run, most notably public sector wages and pensions. The agreement with the IMF should contribute to a further decline in the risk premium, which will reduce the likelihood of stronger depreciation pressures in the coming period.

In response to lower inflationary pressures, the National Bank of Serbia reduced its key policy rate significantly – from 16.5% to 10% April–November. In addition to lessened inflationary pressures, key policy rate cuts were also motivated by the fact that commercial banks were willing to accept lower yield on repo bills in the prior period amid lower risk premium, stabilisation of the exchange rate and declining inflation expectations.

In spite of it all, monetary policy, which had been expansionary in H1, turned out neutral in Q3 as the appreciation gap re-opened neutralising the effect of key policy rate cuts. There is no doubt, however, that monetary policy will resume expansionary character with the lowering of the key policy rate in Q4.

Projection assumptions

Relying on government announcements, we expect no major regulated price revisions until the end of the year, save for the prices of petroleum products. As for the next

year, the projection assumes that regulated prices will reach the upper bound of the growth planned (9±2%).

We expect a further drop in the risk premium, which will, together with the rise of the real exchange rate appreciation trend, cause the real interest rate trend to decline.

In terms of external factors, the projection assumes a certain economic recovery in the euro area which would, together with an inflation rise, create the preconditions for the ECB to slightly raise its policy rate. World oil prices are expected to grow at a moderate pace.

under the impact of the global economic recovery, especially in 2011. On the demand-side, disinflationary pressures will come from the nominal freeze on public sector wages and pensions until end-2010.

Besides, the re-opening of the appreciation gap of the real exchange rate in Q3 means that no inflationary effects, at least for some time, can be expected in that respect either.

It should be noted that no major depreciation pressures are anticipated in the coming period, especially now that the agreement with the IMF has been reached. The stability of the exchange rate is also underpinned by the significant decrease of the current account deficit, return of savings into the banking system, and easier access to foreign borrowing for domestic banks and enterprises.

Table IV.1.1 **Projection assumptions for 2009 and 2010**

	2009	2010
External assumptions		
EU inflation (Dec to Dec)	0.4%	1.3%
ECB policy rate (year-end)	1.0%	1.3%
Euro area GDP growth	-3.9%	1.2%
Ural oil price per barrel (intra-year growth)	80%	10%
Internal assumptions		
GDP growth	-2.8%	1.5%
Regulated prices excl. petroleum products (Dec to Dec)	11.2%	11.0%
Prices of agricultural products (Dec to Dec)	5.5%	10.2%
Trends		
Real exchange rate trend (average)	1.4%	2.6%
Real interest rate trend (average)	6.2%	5.0%

Inflation projection

The central projection places end-2009 inflation at 7.5%, within the band of 6.4–8.6%. In H1 2010 inflation is projected to revolve around the lower bound of the target band, coming closer to its midpoint later on.

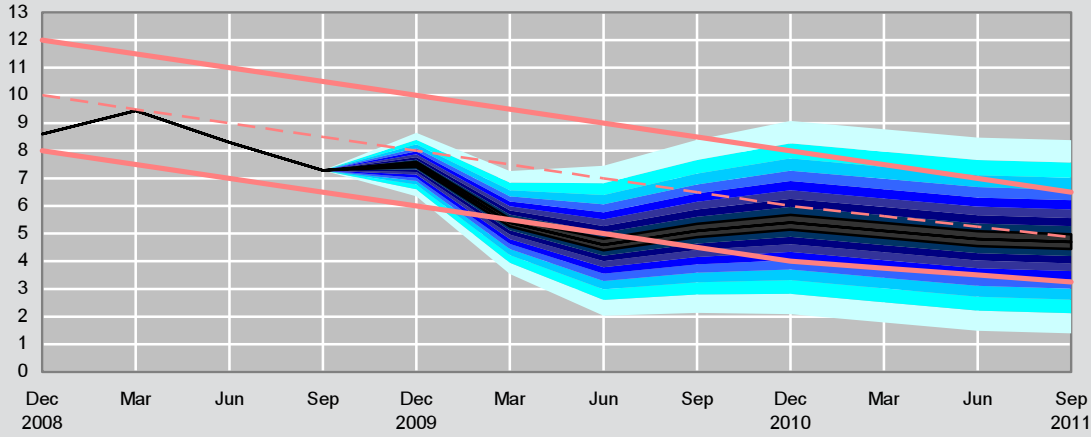
Short-term inflationary pressures are weak: regulated prices will remain broadly unchanged until the end of the year, the exchange rate is stable, and relatively low prices of agricultural products will continue to put downward pressure on processed food prices. Coupled with persistently low demand, this should result in relatively low monthly inflation rates in Q4, with December most likely seeing a year-on-year inflation rate below the midpoint of the target band.

Over the medium-term, low demand is the key disinflationary factor. Output gap, as the demand-side measure, is likely to remain negative throughout the forecast period. Some narrowing, however, is expected

The dinar could weaken, but only moderately, in response to monetary easing, which is consistent with the inflation projection. The weakening of the dinar, if any, would generate some inflationary effects as it would lead to an increase in imported inflation and re-opening of the depreciation gap.

Even if this happens, dampened aggregate demand will keep the 2010 inflation at bay. In H1, year-on-year inflation will revolve around the lower bound of the target band, maybe even dipping below it in some months, whereas from mid-year, it is expected to gradually rise to the target band's midpoint. The drop in the year-on-year inflation rate in H1 will be due, among other things, to the high base, i.e. high monthly inflation rates recorded in the first half of 2009.

Chart IV.1.1 **Inflation projection**
(y-o-y rates, in %)



Inflation is most likely to move below the midpoint of the target band in the coming period, with the risk of undershooting its lower bound in the first half of 2010.

The fan chart depicts probability of various inflation outcomes in the next eight quarters. Central projection is within the darkest central band and the probability that inflation would lie in it is 10%. Outturns of inflation are also expected to lie somewhere within the entire fan chart with probability of 90%. In other words, the probability that inflation in the next eight quarters would lie somewhere outside the band in the chart is 10%.

Risks to the projection

Successful completion of the second review of the arrangement with the IMF has considerably lessened the risks to inflation outlook, most notably those relating to possibly expansionary character of fiscal policy and emergence of stronger depreciation pressures.

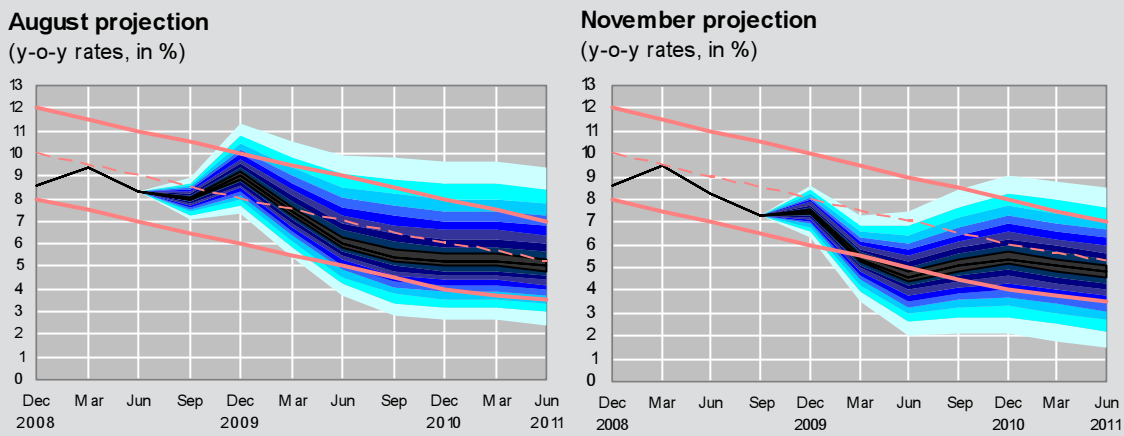
The key risks to the inflation projection are now those regarding non-core inflation: regulated prices and prices of agricultural products. While the risks coming from regulated prices are broadly balanced, those from agricultural product prices are asymmetrical to the upside.

The projection assumes 11% growth in regulated prices in 2010. However, experience teaches us that there may be significant deviations in this respect. In the event of a slump in fiscal revenue, the government may resort to larger increases in regulated prices. On the other hand, such increases could be averted by the drop in the standard of living. Hence, we believe that there are risks to the regulated price outlook in each direction.

In the medium-term, agricultural product prices pose an upside risk to inflation. They are currently very low as the agricultural year has been good and as the corresponding international prices have declined. Owing to this, the rise in processed food prices is much slower. However, we should not completely disregard the possibility of a reversal in their trend amid gradual recovery of the global economy and possibly weaker agricultural performance next year.

For these reasons, from Q3 2010 onwards the projection band is mildly asymmetrical to the upside.

Chart IV.1.2 **Current v. previous projection**



Inflation projection for end-2009 and H1 2010 is lower than the one published in the August Report, while projection for the remaining period is more or less the same. The November inflation projection band is less asymmetrical to the upside as the risks to inflation outlook have subsided with the positive outcome of negotiations with the IMF and complete abandonment of the idea of a VAT increase.

Table IV.1.2 **Changes in projection assumptions for 2009**

	August projection		November projection	
	2009	2010	2009	2010
External assumptions				
EU inflation (Dec to Dec)	0.6%	1.3%	0.4%	1.3%
ECB policy rate (year-end)	1.0%	1.25%	1.0%	1.25%
Euro area GDP growth	-4.4%	0.4%	-3.9%	1.2%
Ural oil price per barrel (Dec to Dec)	70%	10%	80%	10%
Internal assumptions				
GDP growth	-3.6%	1.5%	-2.8%	1.5%
Regulated prices excl. petroleum products (Dec to Dec)	13.9%	12.0%	11.2%	11.0%
Prices of agricultural products (Dec to Dec)	9.3%	9.0%	5.5%	10.2%
Trends				
Real exchange rate trend (average)	1.3%	2.6%	1.4%	2.6%
Real interest rate trend (average)	6.2%	5.0%	6.2%	5.0%

Comparison with the previous projection

Inflation projection for end-2009 and H1 2010 is lower than the one published in the August *Report*, while projection for the remaining period is more or less the same.

The current inflation projection is lower due to the fact that non-core inflation (regulated prices and agricultural product prices) in H2 2009 is lower than anticipated at the time of the August Report, and this will directly feed into year-on-year inflation rates until Q2 2010.

In the medium-run, there are no major differences between the two projections as the underlying movements in medium-term factors and assumptions are very similar. Therefore, the projected inflation outturns from mid-2010 onwards are approximately the same under both projections.

Furthermore, both projections assume a more or less the same pace of monetary easing as the monetary policy rule is based on the one-year ahead inflation deviation from the target, meaning that the above differences in projections for the first half of 2010 have no impact on the monetary authorities' decision-making.

Outlook for the key policy rate

Taking into account the current projection and the underlying risk factors, the NBS Monetary Policy Committee judges that the key policy rate is more likely to be lowered in the next period than kept on hold (10%).

There is scope for monetary easing given the low level of demand, freeze on public sector wages until end-2010, stabilisation of the exchange rate and a much slower growth in regulated prices.

Positive outcome of negotiations with the IMF extends the scope for monetary easing further out as the Serbian authorities have committed to cut current fiscal expenditure in the medium-term. Apart from this, the risk premium is expected to continue down, which will significantly reduce the likelihood of the emergence of depreciation pressures.

However, there are some risks lingering. If the recovery in aggregate demand takes place faster or regulated price growth turns out higher than expected (either because of government policy or rising international oil prices), or if high inflation expectations become entrenched in the public mindset, the pace of monetary policy relaxation could be slower or even completely halted.

In any case, the NBS will continue to monitor movements in the relevant factors closely and will timely respond in order to keep inflation on target.

Table A
Indicators of Serbia's external position

	2001	2002	2003	2004	2005	2006	2007	2008	Q1 2009	Q2 2009	Q3 2009
EXTERNAL LIQUIDITY INDICATORS (in %)											
Forex reserves/imports of goods and services (in months)	2.2	2.8	3.3	2.7	4.3	6.3	5.2	3.8	7.6	8.131781	8.648542
Forex reserves/short-term debt	114.0	223.5	336.3	425.0	385.9	717.3	729.8	336.4	412.4	516.4	486.0
Forex reserves /GDP	10.3	13.6	16.3	16.3	24.2	38.4	32.6	24.2	24.5268	27.60534	30.79486
Debt repayment/GDP	0.8	1.4	2.0	3.9	4.6	7.0	10.0	10.5	10.2	12.7	10.2
Debt repayment/exports of goods and services	3.8	7.0	9.0	16.5	17.7	23.5	33.9	34.8	36.4	44.1	37.1
EXTERNAL SOLVENCY INDICATORS (in %)											
External debt/GDP	98.3	67.2	62.3	54.3	64.2	63.3	60.2	64.7	64.8	67.4	70.4
Short-term debt/GDP	9.1	6.1	4.8	3.8	6.3	5.3	4.5	7.2	6.0	5.3	6.4
External debt/exports of goods and services	463.9	344.8	281.6	232.3	245.1	214.2	204.8	214.7	221.9	236.0	252.7
FINANCIAL RISK EXPOSURE INDICATORS (in %)											
Forex reserves/M1	135.9	143.3	195.3	221.0	291.1	356.5	306.9	300.3	366.2	372.4	383.4
Forex reserves/reserve money	136.3	132.0	168.0	166.2	170.3	177.8	173.9	140.6	160.9	177.1	193.3
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	60.3	59.4	63.6	73.2	73.4	80.4	82.1	83.4	76.2	71.8	68.3
MEMORANDUM: (in USD million)											
GDP (in EUR million)	12,821	16,034	17,416	19,075	20,358	23,521	29,543	33,734	6,644	7,409	8,089
External debt	12,609	10,768	10,857	10,355	13,064	14,884	17,789	21,800	21,445	21,687	21,784
External debt servicing	102	218	348	736	945	1,635	2,885	3,531	676	941	824
Central bank foreign exchange reserves	1,325	2,186	2,840	3,117	4,935	9,025	9,641	8,160	8,113	8,885	9,523
Short-term debt	1,163	978	844	733	1,279	1,258	1,321	2,426	1,966	1,721	1,960
Current account balance	312	-690	-1,356	-2,640	-1,765	-2,381	-4,615	-5,786	-818	-175	-273

	Nov 2004	July 2005	Feb 2006	June 2007	March 2008
CREDIT RATING	Standard & Poor's: B+	Standard & Poor's and Fitch: BB-	Standard & Poor's: BB-/positive; Fitch: BB-/stable	Standard & Poor's: BB-/stable; Fitch: BB-/stable	Standard & Poor's and Fitch: BB- /negative

Methodological notes:

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

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

Debt repayment/GDP (in %) - ratio of debt repayment to GDP during period under review.

Debt repayment/exports (in %) - ratio of debt repayment to exports of goods and services during period under review.

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

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

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

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

Notes:

1. As of October 2006, the IMF publication "International Financial Statistics" features a page on monetary statistics of the Republic of Serbia. This required the NBS to bring its statistical reports in compliance with international statistical standards and methodology which apply to all IMF member countries. We have therefore adjusted the financial risk exposure indicator.
2. Trade with Montenegro is registered within relevant transactions as of 2003.
3. Foreign debt repayment does not include early debt repayment
4. GDP for 2008 and 2009 as estimated by the National Bank of Serbia.
5. In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.

Table B
Key macroeconomic indicators

	2001	2002	2003	2004	2005	2006	2007	2008	Q1 2009	Q2 2009	Q3 2009
Real GDP growth (in %)	5,6	3,9	2,4	8,3	5,6	5,2	6,9	5,5	-4,2	-4	-2.3[1]
Consumer prices (in %, relative to the same month a year earlier)[2]	40.7	14.8	7.8	13.7	17.7	6.6	11.0	8.6	9.4	8.3	7.3
Core inflation (in %, relative to the same month a year earlier)[2]	20.5	4.4	6.1	11.0	14.5	5.9	7.9	10.3	10.2	6.9	5.7
NBS foreign exchange reserves (in USD million)	1,325.1	2,186.0	2,839.5	3,117.3	4,935.1	9,024.8	9,640.7	8,160.4	8,113	8,885	9,523
Exports (in EUR million)[3]	2,718	3,123	3,856	4,458	5,330	6,949	8,686	10,152	1,859	2,135	2,218
- growth rate in % compared to a year earlier	21.1	14.9	23.5	15.6	19.6	30.4	25.0	16.9	-21.2	-18.2	-20.2
Imports (in EUR million)[3]	-5,016	-6,399	-7,220	-9,500	-9,613	-11,971	-15,578	-17,956	-3,201	-3,186	-3,306
- growth rate in % compared to a year earlier	32.3	27.6	12.8	31.6	1.2	24.5	30.1	15.3	-22.5	-31.7	-31.0
Current account balance[4]											
(in USD million)	-318	-1,314	-1,251	-2,278	-1,804	-3,137	-4,615	-5,786	-818	-175	-273
as % of GDP	-2.5	-8.2	-7.2	-11.9	-8.9	-13.3	-15.6	-17.2	-12.3	-2.4	-3.4
Unemployment according to the Survey (in %)[5]	12.2	13.3	14.6	18.5	20.8	20.9	18.1	14.0	/	15.6	/
Wages (average for the period, in EUR)	89.9	151.7	176.7	194.4	210.4	260	347	403	321	338	341
RS budget deficit/surplus (in % of GDP)[6]	-0.2	-4.3	-2.6	-0.3	0.3	-1.9	-1.7	-1.8	-3.7	-5.8	/
Consolidated fiscal result (in % of GDP)											
- Ministry of Finance methodology	0.0	-1.8	-2.1	1.1	1.2	-1.1	-1.4	-2.2	-1.9	-6.6	-4.1
- IMF methodology	-0.5	-2.6	-2.7	0.7	0.7	-2.0	-2.1	-2.5	-1.9	-6.6	-4.1
RS public debt (external + internal, in % of GDP)[6]	97.6	76.4	69.9	55.4	48.0	39.6	30.6	26.1	27.1	29.4	32.0
RSD/USD exchange rate (average, in the period)	66.68	64.46	57.56	58.39	66.70	67.10	58.44	55.76	72.12	69.09	65.24
RSD/USD exchange rate (end of period)	67.67	58.98	54.64	57.94	72.22	59.98	53.73	62.90	71.59	66.25	63.60
RSD/EUR exchange rate (average, in the period)	59.78	60.68	65.05	72.57	82.92	84.16	79.98	81.44	93.93	94.15	93.24
RSD/EUR exchange rate (end of period)	59.71	61.52	68.31	78.89	85.50	79.00	79.24	88.60	94.78	93.44	93.01
Memorandum											
GDP (in USD million)[7]	12,821	16,034	17,416	19,075	20,358	23,521	29,543	33,734	6,644	7,409	8,089

[1] NBS estimate.
[2] Retail prices until 2006.
[3] Trade with Montenegro is registered within relevant transactions as of 2003.
[4] In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.
[5] Source: Labour Force Survey, Statistical Office.
[6] Source: RS Ministry of Finance Bulletin.
[7] GDP in 2008 - NBS estimate.

Appendix 1. Changes in reserve requirements and prudential measures relating to lending activity

A chronological overview of changes in reserve requirements, temporary measures, prudential measures relating to lending activity and special measures is available on the NBS website, under Publications – *Inflation Report.*

A) Changes in reserve requirements

Since the August *Inflation Report*, as at 5 November 2009, decisions on bank reserve requirements have not been amended.

B) Prudential measures relating to lending activity

Since the August *Inflation Report*, as at 5 November 2009, decisions on prudential measures related to lending activity have not been amended.

Appendix 2. Special measures supporting the country's financial stability

The Decision on Special Facilities Supporting the Country's Financial Stability came into effect on 8 May 2009 ("RS Official Gazette", No. 34/2009).

Pursuant to Section 3 of the Decision, special facilities for banks offered by the NBS in support of the country's financial stability include:

1) lending facility aimed at providing dinar liquidity – short-term loans with a repayment period of no longer than 12 months;

2) foreign exchange swap transactions with the NBS.

Pursuant to Section 8 of the Decision, for the purpose of utilizing special facilities from Section 3 of the Decision, a bank is required to submit to the NBS, not later than 10 May 2009, the following:

1) a written statement signed by members of the bank's executive board, expressing commitment to:

– enable borrowers to convert their foreign currency loans and foreign currency clause-indexed loans into dinar loans – without charging any additional fee, in line with bank's regulations and risk management procedures,

– reschedule repayment terms of receivables in line with bank's regulations and risk management procedures, by extending the repayment period by at least 12 months, or by at least one fifth of the remaining repayment period if the extension is longer, so as to ensure the reduction in the borrower's monthly obligation, or by altering the repayment terms by reducing the borrower's monthly obligation by at least 20%,

– notify the NBS of the level of exposure of the banking group it belongs to, in the manner and within deadlines established by the NSB, based on the obligation undertaken by bank shareholders;

2) a written statement of its majority shareholders expressing commitment to:

– maintain the exposure of the banking group to the Republic of Serbia over 2009 and 2010 at least in the amount as at 31 December 2008,

– provide for maintenance of the bank's capital adequacy and liquidity ratios at the levels prescribed, and in the event these ratios fall below the prescribed levels, undertake all necessary measures, within the shortest possible time and in line with regulations,

– if results of stress tests conducted by the NBS show that the bank's capital adequacy ratio might fall below the prescribed level, analyse the causes of such results together with the NBS, and if necessary, examine the possibility of pre-emptive recapitalisation.

Pursuant to Section 9 of the Decision, a bank may use the special facilities as of the date of receipt of the NBS notice of the fulfilment of terms from Section 8 of the Decision, until 31 December 2010 at the latest, and/or until receipt of the NBS notice of bank's default.

The Decision on Supplements to the Decision on Special Facilities Supporting the Country's Financial Stability ("RS Official Gazette", No. 36/2009) came into effect on 18 May 2009. In Section 3, after item 2, item 3 is added to read: "Banks can, instead of 40% envisaged by the Decision on Banks' Required Reserves with the National Bank of Serbia".

The Decision Amending the Decision on Special Facilities Supporting the Country's Financial Stability ("RS Official Gazette", No. 51/2009) came into effect on 18 July 2009, enabling banks to allocate dinar countervalue of 30% of their foreign currency required reserves calculated in euros, instead of 40% envisaged by the Decision on Banks' Required Reserves with the National Bank of Serbia".

The Decision Amending the Decision on Special Facilities Supporting the Country's Financial Stability ("RS Official Gazette", No. 83/2009) came into effect on 18 October 2009, enabling banks to allocate dinar countervalue of 25% of their foreign currency required reserves calculated in euros, instead of 40% envisaged by the Decision on Banks' Required Reserves with the National Bank of Serbia".

Index of charts and tables

Charts

Tables

Sources of data: the National Bank of Serbian and Serbian Statistical Office, unless otherwise stated.

Meetings of the Monetary Policy Committee of the National Bank of Serbia and key policy rate changes

MPC meetings held	Key policy rate (annual level, in %)	Change (in basis points)
2008		
17 January	10.00	0
6 February	10.75	+75
18 February	10.75	0
28 February	11.50	+75
13 March	14.50	+300
28 March	14.50	0
17 April	14.50	0
24 April	15.25	+75
15 May	15.25	0
29 May	15.75	+50
12 June	15.75	0
1 July	15.75	0
17 July	15.75	0
29 July	15.75	0
2 September	15.75	0
16 September	15.75	0
1 October	15.75	0
17 October	15.75	0
31 October	17.75	+200
18 November	17.75	0
1 December	17.75	0
8 December	17.75	0
22 December	17.75	0
2009		
22 January	16.50	-125
29 January	16.50	0
12 February	16.50	0
2 March	16.50	0
20 March	16.50	0
6 April	15.00	-150
22 April	14.00	-100
5 May	14.00	0
22 May	14.00	0
8 June	13.00	-100
25 June	13.00	0
10 July	12.00	-100
10 August	12.00	0
4 September	12.00	0
24 September	12.00	0
6 October	11.00	-100
28 October	11.00	0
5 November	10.00	-100
Scheduled MPC meetings		
13 November		
4 December		
24 December		

Tentative Calendar of Regular MPC Meetings for 2010

2010
11 January
21 January
4 February
19 February
5 March
19 March
6 April
20 Apri
6 May
20 May
4 June
22 June
6 July
20 July
5 August
19 August
7 September
21 September
7 October
21 October
5 November
19 November
7 December
21 December

Press Releases from NBS Monetary Policy Committee Meetings

Press release from the MPC meeting held on 4 September 2009

After reviewing current economic developments in its meeting today, the NBS Monetary Policy Committee decided to keep the key policy rate unchanged at 12 percent.

In today's meeting, the MPC also adopted the August 2009 Inflation Report. The next MPC meeting is scheduled to take place on 23 September.

Press release from the MPC meeting held on 23 September 2009

After reviewing current economic developments, the NBS Monetary Policy Committee decided to keep the key policy rate on hold at 12 percent.

The next MPC meeting is scheduled for 8 October.

Press release from the MPC meeting held on 8 October 2009

After reviewing current economic developments, the NBS Monetary Policy Committee decided to lower the key policy rate by one percentage point. As of today, the key policy rate equals 11 percent.

The MPC also adopted amendments to the Decision on Special Facilities Supporting the Country's Financial Stability pursuant to which banks may allocate in dinars 25%, instead of the currently applicable 30%, of the foreign exchange required reserves calculated in euros. The amendments will enter into force on 18 October.

Governor Jelašić will elaborate on the rationale behind the monetary easing and change in the structure of reserve requirements in a press conference later in the day.

Press release from the MPC meeting held on 28 October 2009

After reviewing current economic developments, the NBS Monetary Policy Committee decided to keep the key policy rate unchanged at 11 percent.

The next MPC meeting is scheduled for 5 November.

Press release from the MPC meeting held on 5 November 2009

After reviewing current economic developments, the NBS Monetary Policy Committee decided to lower the key policy rate by one percentage point. As of today, the key policy rate equals 10 percent.

Governor Jelašić will elaborate on the rationale behind monetary easing at a press conference later in the day.