National Bank of Serbia

2010

November

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 Executive Board's decisions[1] and underpin activities of the National Bank of Serbia.

The *Inflation Report* aims to cover information on the current and expected inflation movements and to provide analysis of underlying macroeconomic developments. It also seeks to explain the reasoning behind the Executive Board's decisions and to provide an assessment of monetary policy effectiveness during the previous quarter. Also integral to this Report 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 Executive Board in its meeting of 11 November 2010.

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

Executive Board of the National Bank of Serbia:

Dejan Šoškić, *Governor*

Ana Gligorijević, *Vice Governor*

Bojan Marković, *Vice Governor*

Mira Erić-Jović, *Vice Governor*

[1] In line with the Law on Amendments and Supplements to the Law on the National Bank of Serbia ("RS Official Gazette", No. 44/2010), the Executive Board has assumed all powers of the Monetary Policy Committee.

ABBREVIATIONS

bln – billion
bp – basis point
CEFTA – Central European Free Trade Agreement
CPI – Consumer Price Index
ECB – European Central Bank
EIB – European Investment Bank
EMBI – Emerging Markets Bond Index
FDI – foreign direct investment
Fed – Federal Reserve System
GDP – Gross Domestic Product
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
mln – million
NAVA – non-agricultural value added
OPEC – Organisation of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
q-o-q – quarter-on-quarter
SDR – Special Drawing Rights
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

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I. Overview

Y-o-y inflation accelerated – it overshot the upper limit of the target tolerance band in October.

After six consecutive months below the lower limit of the target, y-o-y inflation moved back within the band in July 2010. Following acceleration in Q3, it came at 8.9% in October and overshot the 6.3±2% target set for that month.

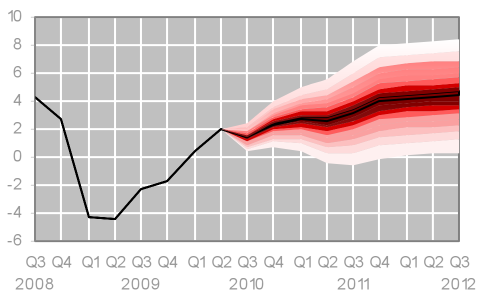
The unexpectedly sharp growth in processed food prices was the key driver of inflation.

Instead of the usual slowdown, inflation stepped up in Q3 (2.6%) in response to core inflation growth spurred by a vigorous rise in processed food prices (7.8%). Moreover, agricultural product prices experienced a smaller than usual seasonal drop (-10.1%).

Though economic recovery is sluggish, the negative output gap is slowly narrowing.

Estimated GDP growth slowed in Q3 due to faltering agricultural output (-5.1%). Rising industrial output (notably manufacturing) and turnover in trade gave the major boost to economic growth. Gradual narrowing of the negative output gap implies not only continuation of disinflationary pressures stemming from depressed aggregate demand, but their gradual weakening as well.

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



GDP growth in 2010 (1.5%) will be sustained by rising export demand. By contrast to 2009, investment will provide a positive though modest contribution, while the impact of overall final spending will be negative. Reflecting a gradual rise in domestic demand, notably investment and export demand, GDP is expected to accelerate to around 3.0–3.5% in 2011.

Efforts to stave off negative trends in the labour market failed again in Q3.

The pace of economic recovery is still insufficient to generate recovery in the labour market. Employment numbers contracted further in Q3. A y-o-y fall came at 3.4%, as a result of shrinking employment by entrepreneurs and in the manufacturing sector. The number of unemployed persons registered by the National Employment Service has been on a decline since early 2010, which, however, is not only the reflection of real economic trends, but of the fact that job seekers failing to report regularly to the Employment Service were struck off records.

Key policy rate hikes notwithstanding, monetary policy assumed a more expansionary edge.

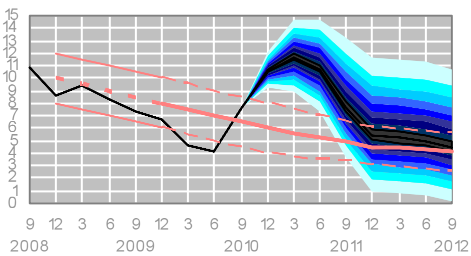
Though the NBS has been raising the key policy rate since August, monetary policy assumed a more expansionary edge in Q3 in response to a weaker dinar and wider real exchange rate depreciation gap. The dinar lost value in response to elevated risk premium and markedly low capital inflows. A smaller rise in the real than neutral rate only amplified monetary policy expansion.

Fourth-quarter inflation will overshoot the target tolerance band, only to subside as of mid-2011 and settle within the band by the year-end.

Inflation growth has been driven by strong upward pressures on food prices, past depreciation of the dinar and moderate recovery of demand aided by the announced increase in public sector wages and pensions. Inflation will move above the target tolerance band in Q4 and for most of 2011. It is expected to fall back within the band by end-2011 (4.5±1.5%).

The key risks to inflation projection relate to movements in food prices, inflation expectations and the risk premium.

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



Uncertainties over the coming period are associated with movements in prices of primary agricultural commodities, but also with the degree to which the change in these prices will feed through into processed food prices. Additional pressures may arise from inflation expectations and the risk premium. Risks to the projection are tilted to the upside due to the possibility of faster than expected growth in food prices and stronger pass-through of dinar's depreciation to prices.

Further upward revision of the key policy rate is likely in the coming period, as well as the increase in monetary policy restrictiveness through the use of other instruments.

Based on the current inflation projection and its underlying risks, the NBS Executive Board judges that further upward revision of the key policy rate is likely in the coming period, as well as the increase in monetary policy restrictiveness through the use of other instruments.

II. Monetary policy since the August Report

The widening of the depreciation gap of the real exchange rate and the real interest rate trend rise gave the monetary policy in Q3 a more expansionary edge.

Anticipating stronger inflationary pressures, the NBS Executive Board raised the key policy rate since August in three steps of 50 basis points each to the current rate of 9.5%. The Board holds that strengthening in inflationary pressures is largely attributable to the increase in inflation expectations spurred by the rising food prices. Heightened inflationary pressures, albeit to a smaller degree, also reflect the recovery of aggregate demand and past depreciation of the dinar that will continue to feed through into import prices for some time yet. Economic growth estimated at 1.5% in 2010 and 3–3.5% in 2011, as well as sooner than planned unfreezing of public sector wages and pensions are seen as clear signals of the recovery in aggregate demand.

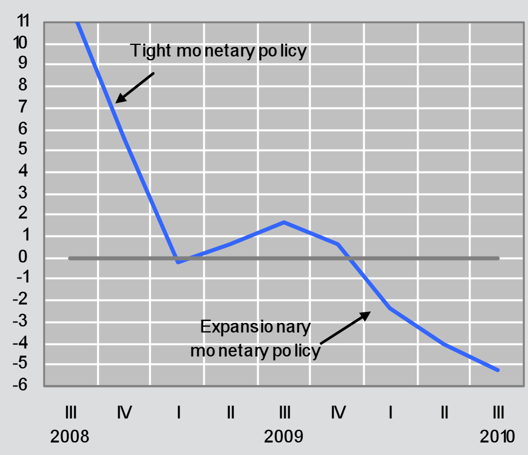
Contrary to expectations at the time of the August Report, it is quite certain that inflation will already in October exceed the upper end of the target tolerance band set for that month (6.3±2%). This trend is likely to prevail until end-2010 and throughout H1 2011 as the effects of one-off food price hikes reflect on annual inflation rates up to 12 months ahead. Nonetheless, in H2 2011 inflation is expected to gradually fall back to the target set for the year-end at 4.5±1.5%. In addition to monetary policy measures, this process will be aided by the stabilisation of food prices provided the supply of agricultural products in 2011 is better than in the current year.

Though the NBS responded to looming inflationary pressures by raising the key policy rate and thus signalled a tightening bias, the real Monetary Conditions Index (MCI) points to an increase in the degree of monetary expansiveness. What gave the monetary policy a more expansionary edge compared to a quarter earlier was further widening of the depreciation gap of the real exchange rate and, to a lesser degree, the rise in real interest rate trend.

The depreciation gap of the real exchange rate widened further as average nominal depreciation of the dinar (3.6%) exceeded the difference between domestic and foreign inflation. Over the medium run, it could develop into a significant inflationary factor.

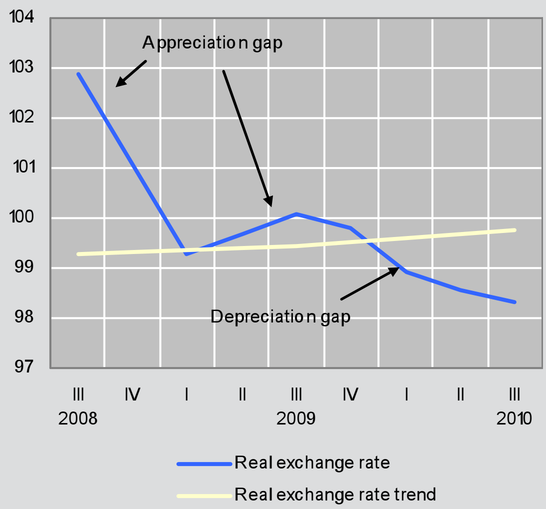
Real two-week BELIBOR continued below the neutral level – by around 230 basis points on average. The neutral rate rose more than the real rate, making the

Chart II.0.1 **Monetary Conditions Index**



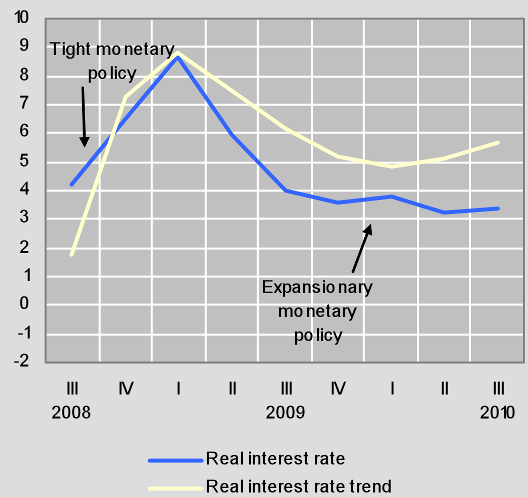
The degree of monetary policy expansiveness increased in Q3.

Chart II.0.2 **Real exchange rate and its trend**
(base index)



Depreciation gap of the real exchange rate widened in Q3.

Chart II.0.3 **Real interest rate and its trend**
(in %)



Even though it recorded an increase, real interest rate had a stronger inflationary effect than a quarter earlier.

monetary policy stance more expansionary than in the previous quarter. The real interest trend rise was aided by the growth in country risk premium, but also by the mild increase in interest rates across international money markets. On the other hand, as inflation expectations edged up slightly on the previous quarter, upward revision of the key policy rate led to a smaller increase in the real two-week BELIBOR.

III. Inflation developments

Y-o-y inflation accelerated in Q3 in response to a vigorous rise in processed food prices and a smaller than seasonal drop in agricultural product prices. In September, inflation exceeded the target, but stayed within the target tolerance band.

Fourth-quarter inflation is expected to move above the upper end of the tolerance band (end-year target: 6.0±2%).

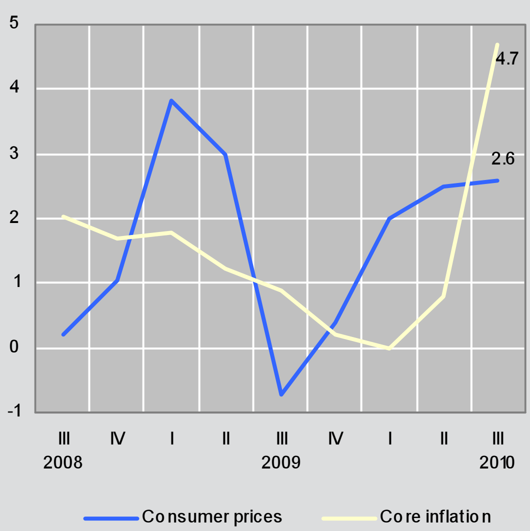
Inflation developments in Q3

The unexpectedly high rate of growth in processed food prices provided the major boost to consumer price growth.

After six consecutive months below the lower limit of the tolerance band, y-o-y inflation moved back within the band in July 2010. It exceeded the target in September, but stayed within the tolerance band. The main trigger of such an outturn was core inflation. Due to the sharp growth in processed food prices (producing a disinflationary effect in the prior period), growth in both y-o-y core and headline inflation stepped up in Q3.

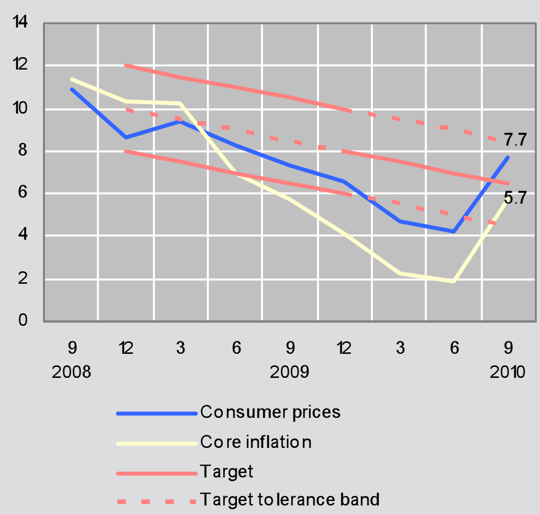
The usual Q3 slowdown in headline inflation failed to take place this year. Headline inflation (2.6%) outpaced that from Q2 (2.5%), reflecting a vigorous rise in processed food prices and a smaller than the seasonal drop in agricultural product prices.

Chart III.0.1 **Price movements**
(quarterly growth, in %)



Core inflation grew much faster than headline inflation, mainly in response the food price hike.

Chart III.0.2 **Price movements**
(y-o-y growth, in %)



Y-o-y headline and core inflation rose at an equal pace, though core inflation trended at a lower level.

Table III.0.1 **Price indicators**
(growth rates, in %)

	XII 2009 / XII 2008	III 2010 / III 2009	VI 2010 / VI 2009	IX 2010 / IX 2009
Consumer prices	6.6	4.7	4.2	7.7
Core inflation	4.1	2.3	1.9	5.7
Retail prices	10.4	7.4	6.4	8.7
Cost of living	6.6	4.4	3.7	7.2
Industrial producer prices	7.4	11.7	11.3	14.0
Agricultural producer prices	-4.8	-7.3	-3.3	18,7*

* August on August.

A food price hike was caused by the poor performance of agriculture, low food prices relative to those in the neighbouring countries, and the market structure, i.e. cartel behaviour of some market players. The agrarian policy reform, chiefly in regard to commodity reserves, minimum prices, premium setting and subsidising, could dampen food price volatility in the coming period.

Core inflation hit a record quarterly high (4.7%). It picked up in August and September (2.1% each), following the unexpectedly sharp growth in processed food prices (7.8% – contribution of 3.3 pp). The strongest growth was recorded for prices of meat, edible oil, milk, dairy products and bread (64% contribution to growth), due to higher input costs (corn, wheat and sunflower). Growth in non-food prices (components of core inflation) accelerated as well (2.4%), notably due to the depreciation pass-through to prices. Y-o-y core inflation measured 5.7% in September.

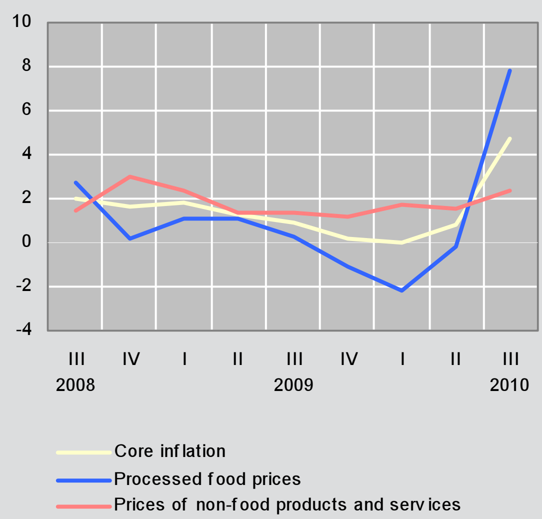
Regulated price growth slowed in Q3 (1.9%), reflecting price hikes in utility services, cigarettes and medicaments. End-Q3 y-o-y regulated price growth came at 10.4%.

A drop in **agricultural product** prices (the most volatile component of headline inflation) was smaller than seasonally expected (-10.1%). Unfavourable weather conditions induced a weaker supply of agricultural products which sustained their high prices. At end-Q3, growth in agricultural product prices measured 15.5% y-o-y.

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

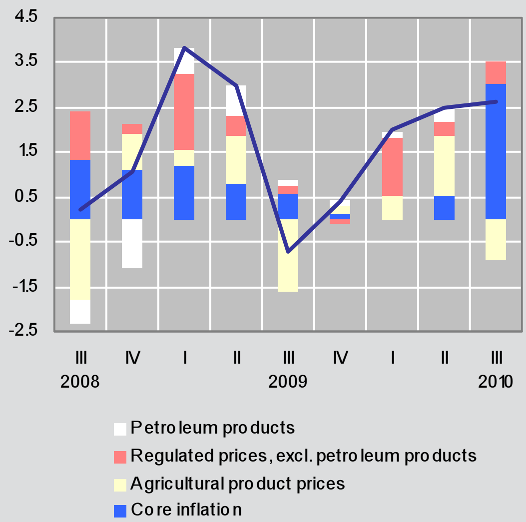
	2009		2010		
	Q3	Q4	Q1	Q2	Q3
Consumer prices	-0.7	0.4	2.0	2.5	2.6
Core inflation	0.9	0.2	0.0	0.8	4.7
Agricultural product prices	-18.5	2.7	7.0	17.0	-10.1
Regulated prices	1.1	0.5	5.5	2.3	1.9
Electricity	0.0	0.0	11.5	0.0	0.0
Petroleum products	2.3	3.5	3.0	6.8	0.8
Gas for households	0.0	0.2	0.0	0.0	0.0
Utility-housing services	6.0	1.0	4.2	1.3	5.9
Social welfare services	3.3	8.7	3.7	0.3	0.0
Transport services (regulated)	0.0	0.1	2.3	0.2	1.7
Postal and telecommunications services	1.9	0.0	0.0	0.5	0.0
Bread of wheat flour T-850	0.6	-2.8	-0.8	0.2	3.8
Cigarettes	0.0	0.0	10.2	0.0	5.6
Medications	-1.3	-2.7	0.2	5.0	1.8
Other	0.1	0.0	0.6	12.6	0.8

Chart III.0.3 **Core inflation by component**
(quarterly growth, in %)



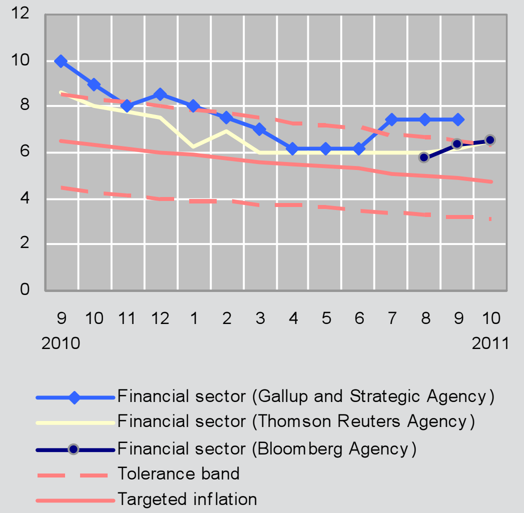
Core inflation growth in Q3 was driven by rising prices of non-food products and services.

Chart III.0.4 **Contribution to quarterly consumer price growth**
(in percentage points)



Market determined prices lent the strongest boost to overall consumer price growth.

Chart III.0.5 **One-year ahead expected and targeted inflation**
(in %)



One-year ahead inflation expectations of the financial sector edged up somewhat.

Inflation expectations

Financial sector inflation expectations edged up mildly in Q3.

Notwithstanding a food price hike, inflation expectations edged up mildly in Q3 as a result of increases in the key policy rate. According to a recent **Medium Gallup survey**, one-year ahead financial sector expectations rose in July to stabilise at 7.4%. Trade unions and households within the corporate sector raised their expectations.

Judging by **Thomson Reuters and Bloomberg surveys**, financial sector expectations rose to some extent, settling by end-Q3 at 6.2% (Thomson Reuters) and 6.3% (Bloomberg).

At end-Q3, one-year ahead financial sector inflation expectations trended above the upper end of the target tolerance band.

In October, as indicated by Thomson Reuters and Bloomberg surveys, financial sector inflation expectations went further up (to 6.5% in both agencies).

The early September MRI[2] survey covering entrepreneurs shows that one quarter of respondents expect a hike in their product prices over the next three months (vs. around 15% in the earlier survey). The strongest inflationary pressures are recorded in the consumer goods sector.

Inflation outlook for Q4

Inflation is expected to move above the upper end of the target tolerance band in Q4.

Inflation movements in the last quarter will reflect the rise in inflation expectations driven by food price

[3] Market Research Institute.

increases over the past several months. Inflationary pressures, albeit to a smaller degree, will also emanate from the past depreciation of the dinar and the recovery of aggregate demand.

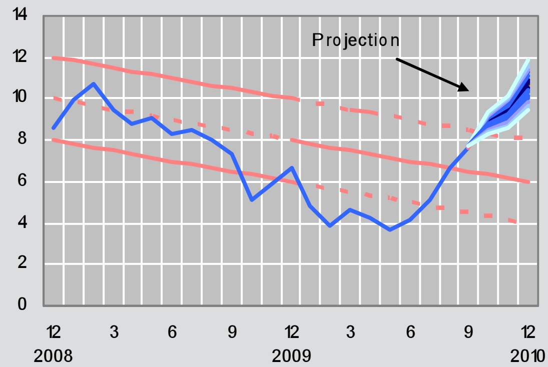
Y-o-y inflation is expected to move above the upper end of the target tolerance band in Q4. Its growth will in part be due to low monthly inflation rates recorded in late 2009.

Core inflation is expected to slacken, though its monthly rates will continue to be relatively high. Growth in processed food prices will in large part depend on future movements in input prices. The prices of non-food products should remain stable, revolving around their September level.

Quarterly regulated price growth is likely to slow further. The strongest price increase within this group of products is anticipated for utility services due to the rise in costs of heating. If world oil prices remain at their current level in dinar terms, there will be no change in petroleum product prices in Q4.

As the weather conditions have stabilised, agricultural product prices are expected to follow the typical seasonal pattern of growth.

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



Y-o-y inflation will continue up in Q4.

The greatest uncertianty to the projection is associated with processed food prices that hold a significant share in headline inflation (29.8%)

Box 1: Food prices and the achievement of inflation target

The price hikes in the international market of primary agricultural commodities, observed since July 2010, reflected on our market as well. Though a seasonal decline or even stagnation was expected in August and September, food prices in Serbia rose 7.5%. At the same time, food prices in the neighbouring countries rose much less (or even declined) although these countries also suffered rising prices of primary agricultural commodities. Differences in price movements are the most evident with prices of fresh meat, milk and edible oil. The current price hike was preceded by a decline (in the July 2009 – June 2010 period, food cheapened by 3.2%). Relative to the neighbouring countries, oscillations in food prices in Serbia are rather significant (see Table). In the December 2006 – July 2010 period, the standard deviation of food prices, as a measure of price volatility, stood at 15.7, while ranging in the neighbouring countries from minimum 6 for Croatia to maximum 10.3 for Bulgaria. Similar volatility ratios are also observed in terms of relative food price levels.

Serbian inflation is highly vulnerable to food price shocks because of high volatility of this group of prices and their significant share in the consumer price index. Strong food price oscillations in Serbia are the key reason for the departure of inflation from its 2010 target. Namely, in H1 2010, inflation trended below the lower end of the target tolerance band, mostly due to falling food prices in late 2009 and early 2010. By contrast, we have witnessed over the last several months a strong food price hike caused by unfavourable weather conditions and soaring world prices of primary agricultural commodities, these factors being the main drivers of target overshooting in Q4 2010.

Food price volatility by country (standard deviations)*
Dec. 2006 - July 2010

	Share of food in CPI, 2010	Food prices		Relative food prices**	
		Level	Y-o-y rates	Level	Y-o-y rates
Serbia	34.1	15.7	12.3	5.3	8.1
Bulgaria	19.0	10.3	10.7	4.0	5.6
Hungary	17.0	9.3	5.5	3.5	4.5
Macedonia	34.3	7.6	9.0	3.6	4.7
Romania	32.6	6.9	4.5	2.2	3.0
Slovenia	14.6	6.2	5.7	2.6	3.4
Croatia	25.6	6.0	5.9	2.4	3.6
EU-27	14.2	4.0	3.3	1.6	2.1

* NBS calculation based on Eurostat data.

** Ratio of food prices to general price level.

In the near term, special attention should be given to the adoption of measures to lessen volatility in food prices, at least to the levels observed in comparable countries in the region. To that end, Serbia's efforts to join the EU will certainly give a positive impetus, boosting competition in particular segments of the food market. Furthermore, the impact of high customs duties on food imports will weaken in the medium run as the Stabilisation and Association Agreement envisages gradual trade liberalisation with the EU and complete elimination of customs protection by 2015. In addition, the reforms relating to the advancement of agrarian policy (notably in the field of commodity reserves, minimum prices, premium setting and subsidising, as well as establishment of legal frameworks harmonised with the EU agrarian policy system), could also alleviate future food price oscillations.

IV. Inflation determinants

1. Money market trends

Interest rates

Money market interest rates hiked in early Q3. A sharper rise in lending than deposit rates resulted in widening of bank spreads.

The key policy rate hikes did not reflect on banks' readiness to invest in NBS repo securities. In Q3, the stock of securities sold declined by RSD 41.2 bln. As banks cut their investment further by RSD 3.8 bln in October, the stock of securities sold via repo transactions reached RSD 60.7 bln at the month-end.

Banks' reduced readiness to invest in repo securities and T-bills, and the consequent rise in bank excess funds reflected on movements in the interbank money market. By contrast to end-Q2, BEONIA generally trended below the key policy rate throughout Q3. In September, it averaged 8.7%. The average daily trading volumes in the overnight market remained broadly unchanged at RSD 8.0 bln relative to Q2.

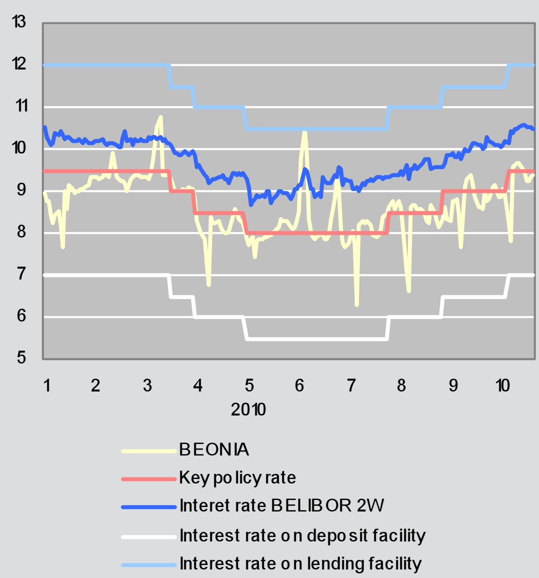
In the period observed, shorter-maturity BELIBOR rates rose somewhat less (0.4 pp – 0.8 pp) than the key policy rate, while 3- and 6- month BELIBOR was up 1.6 pp and 2.2 respectively. As a result, average BELIBOR rates in September ranged between 9.4% and 11.9% and the width of the range remained unchanged in October too (2.4 pp). An increase in the yield curve slope was due mainly to a rise in longer-term BELIBOR, implying banking sector expectations of further interest rate hikes in the coming period. This is confirmed by Reuters and Bloomberg survey findings. Namely, the financial sector expects the key policy rate to stand at 9.5% by end-October and to rise further to 10% by the year-end.

T-bill effective rates continued up in Q3 – those for 6-, 12- and 18-month maturities gained 2.0 pp relative to end-June.

As the government has only been issuing 3-month and 2-year T-bills since July, the executive rates for these maturities recorded a smaller rise by end-Q3 (0.7 pp for 3-month and 0.9 pp for 2-year maturities). Despite higher yield on government securities, investors were not too enthusiastic to increase their purchases. The quarterly auction performance was 61% vs. 81% in Q2 and 100% in Q1. Due to the poor performance of long-term securities, the government reduced the planned nominal issuance volume to mere RSD 27 bln in Q4, while the issue envisaged for 3- and 6- month securities is worth RSD 65 bln.

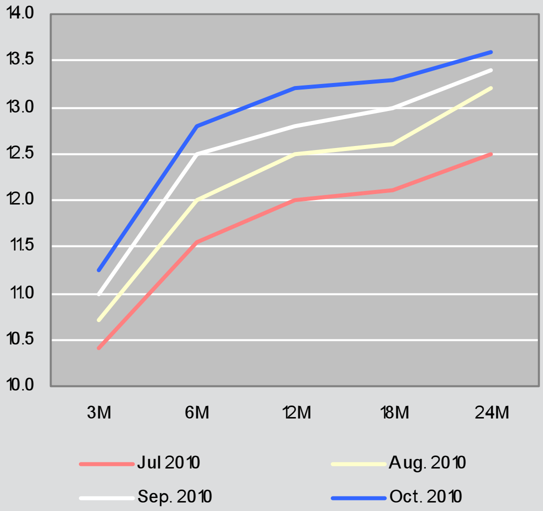
The nominal volume of T-bills sold rose by RSD 15.5 bln in Q3 and reached RSD 152.0 bln by the period-end. However, the stock of bills sold contracted by RSD 5.8

Chart IV.1.1 **Interest rate movements**
(daily data, p.a, in %)



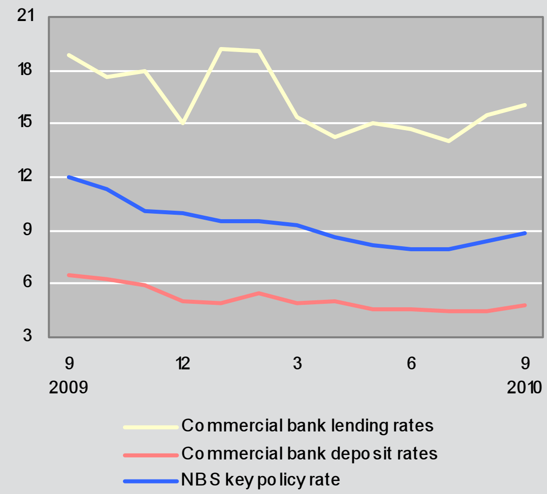
Interest rates in the interbank money market mirrored the rise in the key policy rate.

Chart IV.1.2 **Yield curve in the primary market of government securities**
(p.a, %)



The increase in the yield curve in the primary market of government securities was accompanied with an increase in its slope.

Chart IV.1.3 **NBS key policy rate and commercial bank interest rates***
(weighted average, p.a, in %)



* Lending interest rates refer to both foreign currency-indexed and dinar loans.

A hike in the key police rate impacted more on an increase in lending rates, while deposit rates picked up only slightly.

bln in October as 3-month bills, issued from July, were maturing and auction performances were rather weak.

Total trading in the secondary market arrived at RSD 6.0 bln in Q3. Given the stock of securities sold, the market liquidity ratio[3] is still low – it does not exceed 2% in monthly terms. In October, trading contracted further to RSD 0.6 bln. The yield to maturity rose both in Q3 and October – at end-October, the yield curve for one-week and 18-month maturity equalled 10% and up to 13.4% respectively.

Since August, following the key policy rate hikes, the average interest rates on newly extended corporate and household loans have been on the upside too. In Q3, the rates rose by 1.4 pp to 16.0% p.a. in September, in response to the smaller volume of subsidised lending and a pick-up in interest rates in the European interbank money market. At the same time, the average deposit rates edged up from 4.6% in June to 4.9% in September and bank interest spreads gained 1.1 pp.

Monetary aggregates

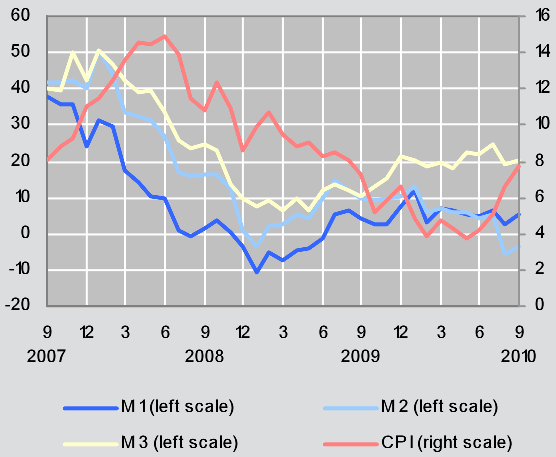
A sluggish pace of economic recovery was followed by a moderate decline in demand for money relative to Q2.

Reserve money continued down in Q3, contracting by 3.4% in real terms. The withdrawal was made through the foreign exchange channel, while dinar transactions pushed reserve money up.

As in the quarter earlier, NBS interventions in the FX market were most conducive to reserve money withdrawal. Hence the decline in FX reserves and NFA by EUR 617 and 439 mln respectively, despite inflows under loan disbursements (Russian Federation, EIB and IMF loans). By end-September, net FX reserves stood at EUR 5,003 mln, calculated at the programme exchange rate, or EUR 403 mln more than the minimum prescribed by the IMF.

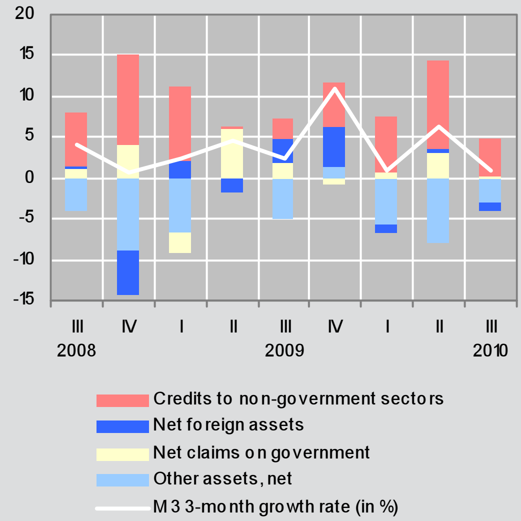
[3] The liquidity ratio of the secondary securities market is the ratio of total monthly trading in the secondary market and the average monthly stock of sold securities. In August, this ratio equalled 11% in Romania and 23% in Hungary.

Chart IV.1.4 **Monetary aggregates and CPI**
(y-o-y rates, in %)



Money supply rose at a weaker pace than prices, partly in response to the immediate application of bankruptcy proceedings over enterprises whose accounts have been blocked longer than three years.

Chart IV.1.5 **Contribution to M3 growth**
(in p.p.)



Though slower than in Q2, bank lending activity contributed most to M3 growth.

Growth in reserve money was driven rather by reduced bank investment in repo securities than by spending of funds from government accounts. Maturing of 3-month swap transactions worth RSD 12.4 bln, through which banks bought foreign currency from the NBS, reduced the effect of reserve money creation through the dinar channel.

During Q3, monetary aggregate M1 gained 1.2% in real terms, while M2 and M3 lost 6.0% and 1.8% respectively. Y-o-y, M1 and M2 fell by 2.4% and 10.3% in real terms respectively, while M3 gained 11.5%.

An increase in transaction deposits was mainly due to higher balances in corporate gyro accounts and a smaller rise in money in circulation. Owing to the implementation of the new Bankruptcy Law, envisaging immediate application of bankruptcy proceedings over enterprises whose accounts were blocked for more than three years, total savings and time deposits declined in Q3. However, as the amount of the decline was smaller than the volume of blocked assets, the funds in accounts of other enterprises rose more than in Q2, implying improved enterprise liquidity relative to Q2. Growth in savings and term deposits picked up in Q3 partly in response to rising interest rates on dinar savings.

Rising household FX deposits (EUR 182 mln) accounted for most of the increase in total FX deposits. To encourage saving in dinars, consistent with its dinarisation strategy, the NBS lifted reserve requirements on all time dinar deposits collected between 31 October and 8 November.

In response to a simultaneous decline in dinar required reserves and the abovementioned contraction in savings

Table IV.1.1 Monetary aggregates
(real y-o-y growth rates, %)

	2009	2010			Share in M3 Sep. 2010 (%)
	Dec.	March	June	Sep.	
M3	14.0	14.6	17.2	11.5	100.0
FX deposits	20.8	22.0	27.6	25.1	69.1
M2	3.7	2.0	0.1	-10.3	30.9
Time and savings dinar deposits	8.5	1.7	-0.8	-20.1	12.3
M1	0.7	2.3	0.7	-2.4	18.6
Demand deposits	1.4	0.7	-1.1	-4.1	11.7
Currency in circulation	-0.5	5.0	4.0	0.7	6.9

and time deposits, monetary multiplier remained unchanged from Q2.

Bank lending to non-governmental sectors is still the main contributor to M3 growth (4.7 pp). During Q3, government net borrowing rose slightly, providing a minimal contribution to M3 growth. Government borrowing by the issue of T-bills continued to rise, while FX liabilities to banks contracted and deposit accounts went up. NFA gave a negative contribution (-1 pp) in response to a reduction in NBS reserves. At the same time, banks' NFA went up.

In October, all monetary aggregates reported a pick-up, with growth in M2 due mainly to a rise in transaction deposits. Household FX savings rose by a slight amount, probably in response to household expectations of a better offer from banks during the Savings Week.

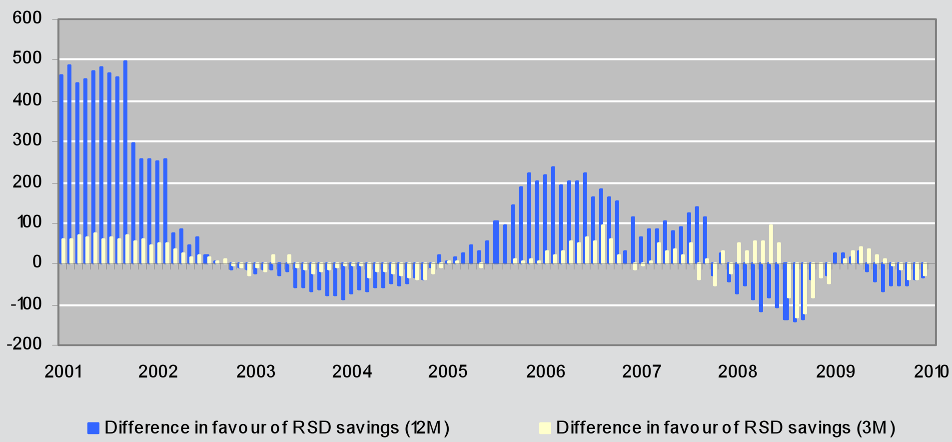
Text box 2: Profitability of savings from 2001 to 2010

As citizens have shown a strong tendency to hold FX rather than dinars in their savings accounts over the last ten years, the question arises as to whether it was really less profitable to hold dinars. To answer that question, we undertook two exercises covering the period from 2001 to 2010 analysing the profitability of savings deposits in rollover accounts and the profitability of savings accounts in different periods over the last ten years[4]. In the calculation of interest on dinar savings, official NBS statistics were used, while the returns on FX savings were worked out based on assumed interest rates. Interest earnings at the end of the savings term were reduced by the amount of the capital gains tax.

In the analysis of profitability of savings deposits in rollover accounts we assumed that one-year deposits of EUR 1,000 and the dinar equivalent of EUR 1,000 were placed every 1 January in the period observed and rolled over each year on the same terms until April 2010 (monthly interest accrual). On 30 April 2010, the amount in the dinar savings account was EUR 2,816, whereas the amount in the euro savings account, assuming the interest rate of 7.5%, was EUR 1,747.

Profitability of savings in different periods from 2001 to 2010

(in EUR)



The analysis of profitability of savings accounts in different periods over the last ten years assumes that one-year and three-month savings deposits in the amount of EUR 1,000 and the dinar equivalent were placed each month in each of the years from 2001 to 2010, and compares their interest earnings at the end of the deposit term. The results suggest that holding dinars in one-year savings accounts paid off better than holding euros in savings accounts with the same maturity date in a larger number of periods. When comparing one-year savings in dinars against savings in euros with the same maturity date and a 5.0% p.a. interest, saving in dinars was more profitable in 67 periods (early 2001–March 2003, December 2004–September 2007 and end-2008–April 2009), while saving in euros was more profitable in 41 periods. The fact that it was more profitable to save in dinars than in FX in a larger number of periods, especially for longer maturities, is attributable primarily to significantly higher interest paid on dinar savings, but also to their more favourable tax treatment. The suspension of the capital gains tax on FX savings in 2009 boosted the profitability of FX savings deposits during that year. Compared against FX savings paying 7% and 7.5%, out of 108 periods in total, saving in dinars was more profitable in 61 and 58 periods, respectively.

Holding dinars in three-month savings accounts was also more profitable in a larger number of periods than holding FX in savings accounts with the same maturity date. At a 5.0% p.a. interest on three-month savings accounts in FX, saving in dinars proved more profitable in 63 periods and saving in FX in 45 periods (see the chart). Compared against FX savings accounts paying 7.0% and 7.5%, saving in dinars turns out to be more profitable in 59 and 58 periods, respectively.

[4] For more details see the Analysis of Profitability of Dinar and FX Savings on NBS website.

Bank lending

After gaining momentum in Q2, lending activity slowed down in Q3. The slowdown was particularly pronounced in the corporate sector.

Reflecting movements in economic activity, lending slowed down in Q3, posting a real growth of 2.9% compared to 5% in Q2. Broken down by sector, household lending rose 4.0% in real terms, while corporate lending went up by 2.4% as a result of a sharper deceleration in growth. Overall bank lending increased RSD 60.2 bln in nominal and RSD 41.3 bln in real terms.[5] Y-o-y data also point to a mild slowdown in lending – its real y-o-y growth rate came at 12.9%, down by 0.4 pp from a quarter earlier.

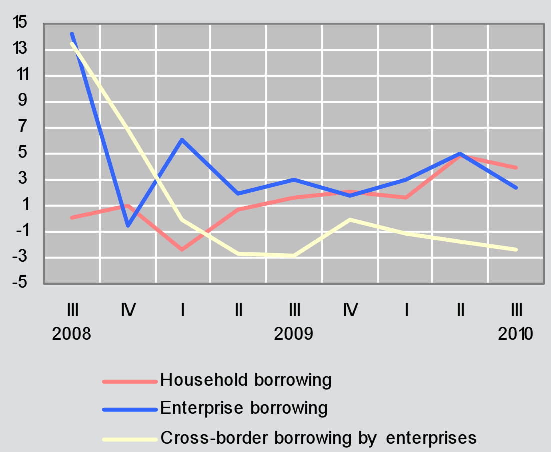
To finance their lending activity, banks relied exclusively on the domestic sources of funding. Most funds came from the decrease in bank reserves with the NBS (2.9 pp contribution), mainly at the expense of repo investments. Banks also tapped into FX deposits, notably those of households (2.1 pp). Besides, as banks invested a portion of their excess funds in the purchase of T-bills, the private sector was crowded out. The increase in banks' net receivables from abroad had a negative impact on overall lending activity. These receivables increased by EUR 318 mln, while at the same time, banks managed to reduce their total foreign debt by EUR 50 mln through short-term debt repayment.

Though corporate lending slowed in Q3, for the first time in two years investment loans outpaced liquidity loans in terms of their quarterly rise. Such an increase in investment loans may be seen as a harbinger of an investment upturn. Considering that a majority of investment loans were taken by businesses engaged in industry, trade and transport, a pickup in economic activity can first be expected in these sectors.

Enterprises continued reducing their foreign financial debt (by EUR 134 mln). On the other hand, the increase in their net trade credits, begun in Q2, reached EUR 336 mln in Q3.

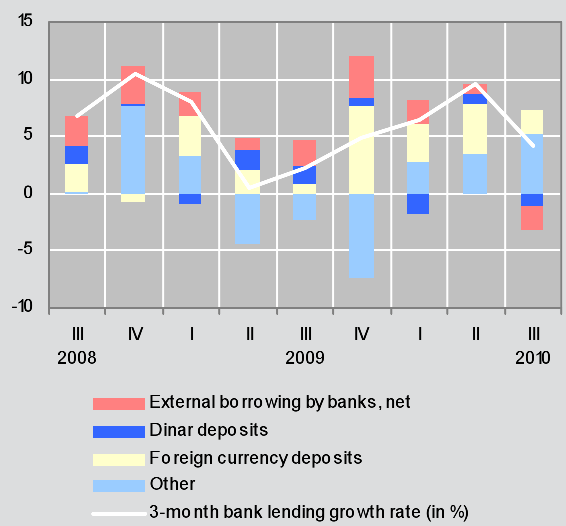
In nominal terms, household loans rose RSD 24.6 bln, most of this amount relating to housing loans. Growth was also recorded with loans extended to agricultural producers, partly due to subsidies from the Ministry of Agriculture. Lending activity contributed to the rise in

Chart IV.1.6 **Real domestic and cross-border borrowing**
(quaterly grow th rates in %)



The slowdown in lending activity was more pronounced in the corporate sector. The volume of cross-broder loans continued declining.

Chart IV.1.7 **Contribution to bank lending growth**
(in p.p.)



Banks financed their lending activity in Q3 exclusively from domestic sources.

[5] Excluding depreciation effects.

household consumption – though consumer loans recorded no increase, the disbursement of cash loans and the use of current account overdraft facilities stepped up.

The subsidised segment of the loan market also saw less activity than a quarter earlier. The volume of loan approvals dwindled, while dinar liquidity loans managed to retain their dominant position. The share of subsidised loans in total new lending declined from the previous quarter to around 14% in September.

The dinarisation strategy is yielding results. An increasing number of loans are approved in dinars and with no foreign currency clause – around 50% of total household and corporate loans in August. As a result, the share of foreign currency clause-indexed receivables in total household and corporate receivables is constantly declining. In September 2010, it measured 70.9%.

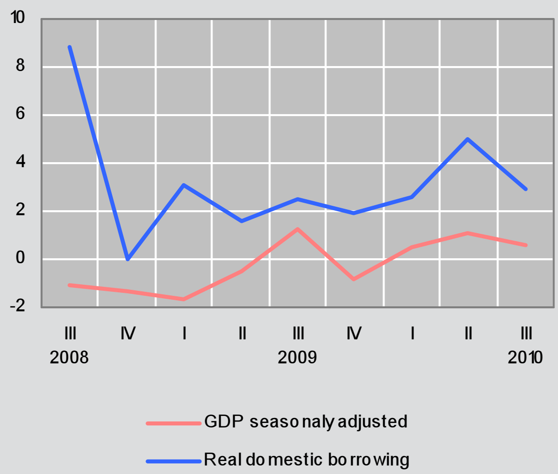
The share of net NPLs increased by 0.3 pp from Q2 to 10.6% in Q3 (17.9% gross). The debt servicing capacity of households remained unchanged relative to June, while that of enterprises deteriorated slightly.

Table IV.1.2 **Subsidised loans in 2010**

	Q1	Q2	Q3
Government Programme of Measures to Ease the Effects of the Global Financial Crisis			
	(in RSD bln)		
Loans approved	**25.6**	**65.6**	**56.3**
Liquidity	22.4	44.6	34.9
Investment	0.4	5.0	9.0
Consumer	2.8	4.1	0.6
Dinar cash		11.9	11.8
Subsidised housing loans			
	3.3	**3.2**	**3.7**
Subsidised loans for agricultural producers			
		3.1	**2.6**

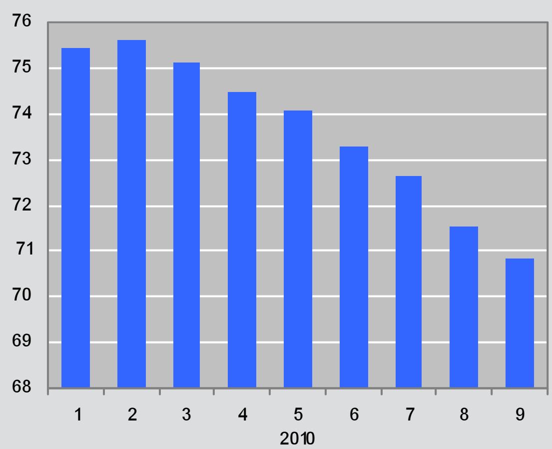
Source: Ministry of Economy and Regional Development, National Mortgage Insurance Corporation and Ministry of Agriculture, Forestry and Water Management.

Chart IV.1.8 **Real domestic borrowing and GDP**
(quaterly growth rates in %)



The slowing of the economy in Q3 was accompanied by the slack in lending growth.

Chart IV.1.9 **Share of FX-indexed receivables in total bank receivables from households and enterprises**
(in %)



The share of FX-indexed receivables continued down.

2. Movements in the foreign exchange market and the exchange rate

The dinar's slide against the euro continued in Q3. Depreciation pressures were a flip side of elevated risk premium and contracted capital inflows.

Depreciation pressures continued into Q3, though with diminishing intensity. In July, the dinar lost 1.1% on average against the euro, while weakening in August and September by 0.6% and 0.1% respectively. Q-o-q, the dinar slid 3.6% vis-à-vis the euro.

Depreciation pressures were generated by elevated risk premium since May, markedly low capital inflows from FDIs and bank and enterprise external debt repayment. However, the FX supply/demand mismatch of bank clients narrowed in response to decreased bank sales of foreign currency to enterprises relative to Q2, the non-residents' reappearance on the FX-sales side and the increased repurchase of cash from exchange offices in August and September. As a consequence, the continued depreciation trend, evident from May to July, was halted in August.

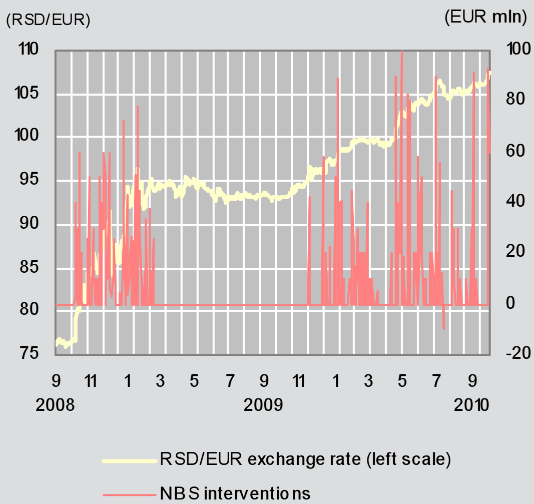
The rise in risk premium, measured by EMBI *(Emerging Markets Bond Index)*, slackened in Q3. EMBI reached 493 bp by end-September, up by around 40 bp from June. In contrast to Serbia, financial market turmoil in other transition countries lessened from June and EMBI stopped rising. By end-October, EMBI eased to 473 bp.

To alleviate excessive daily volatility of the dinar and/or encourage trading, the NBS intervened in the IFEM by selling EUR 585.2 mln net (for the most part in July – EUR 221 mln). This notwithstanding, interbank trading (NBS excluded) declined from Q2 – the average daily trading volume was around EUR 34 mln.

The dinar was stable throughout October, only to depreciate by the end of the month due to high enterprise demand for foreign currency. In October, the dinar lost 0.8% on average against the euro, and the NBS sold to banks EUR 173 mln. The average daily interbank trading remained at the Q3 average.

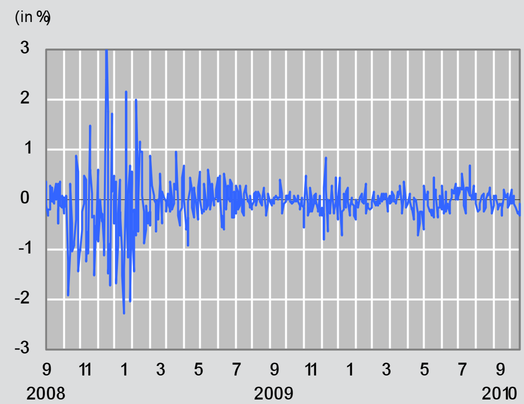
Starting from July, the NBS discontinued its practice of holding 3-month FX swap purchase/sale auctions. Since they were first launched in April 2010, in support of the development of the interbank swap market, EUR 152.5

Chart IV.2.1 **Movements in RSD/EUR exchange rate and NBS FX interventions**



Depreciation pressures and NBS interventions continued in Q3, though with lower intensity.

Chart IV.2.2 **Daily changes in RSD/EUR exchange rate***



* Negative rates indicate depreciation and positive rates appreciation of the dinar.

The dinar was losing ground, though its daily volatility was less pronounced than in Q2.

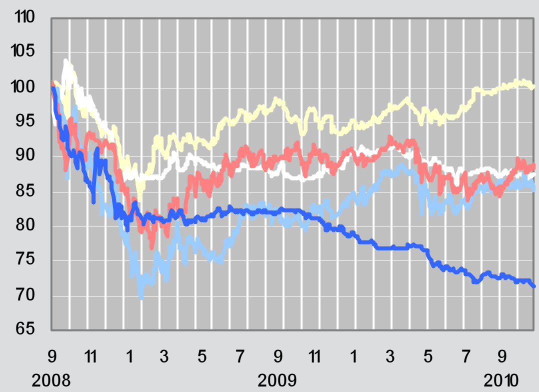
mln were swap purchased by the NBS and EUR 119.2 mln sold to banks. The first interbank swap transactions were recorded in late September.

As the strengthening of the dollar against the euro went into a reverse in Q3, accelerated depreciation of the dinar vis-à-vis the dollar from Q2, was discontinued and the dinar lost around 2% against the dollar in Q3. Due to stronger weakening of the nominal effective exchange rate of the dinar[6] (3.4%) than a rise in domestic relative to foreign prices, the real effective depreciation equalled 1.3% in Q3 (1.5% and 0.3% against the euro and the dollar respectively). Owing to further appreciation of the euro against the dollar, the dinar gained around 6% against the dollar.

According to the November Bloomberg survey, the financial sector expects minor depreciation of the dinar until the year-end.

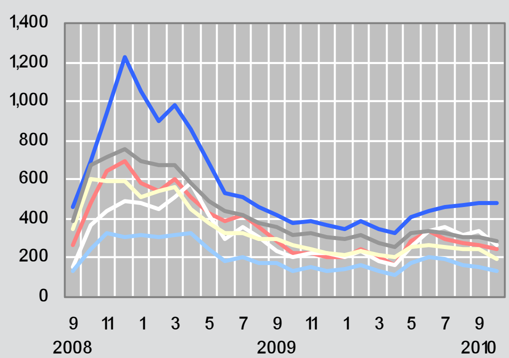
In earlier years, depreciation pressures would usually build up in a fourth quarter under the impact of seasonal factors. However, the importance of the seasonal effect on exchange rate movements is expected to diminish in the coming period due to the activities of the NBS and other market players relating to dinarisation of the financial system, improvement of FX hedging instruments, and the opening of the gas storage facility in Banatski Dvor.

Chart IV.2.4 **Movements in exchange rates of national currencies against the euro**
(Sep 30, 2008 = 100)



It was only the Czech Republic that saw a rise in its currency against the euro in Q3.

Chart IV.2.3 **Risk premium indicator – EMBI by country**
(monthly averages, in basis points)



Source: JP Morgan.

Unlike Serbia, other countries have been recording a fall in risk premium since July.

Foreign capital inflow

Movements in the interbank foreign exchange market reflected a rather low inflow of capital in Q3.

Net FDI inflow was quite modest – EUR 176 mln, more than half of it registered in July alone. It was almost negligible in August and September: EUR 44 and 31 mln, respectively. Most FDI flowed into the financial sector, steel industry, beverage production and trade. Net inflow under portfolio investment amounted to EUR 16 mln.

Foreign exchange also flowed in through the Stand-By Arrangement with the IMF. Around 15% of the amount available under the fifth tranche was drawn in September (EUR 53.5 mln)[7]. However, intended as support to the country's international reserves, this inflow had no impact on movements in the interbank foreign exchange market.

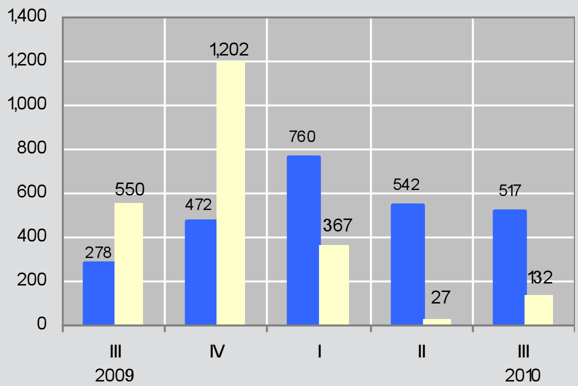
Banks and enterprises continued to net repay their foreign debt in Q3. Though banks paid off EUR 105 mln, most of

[6] Weights used: 0.8 and 0.2 for the euro and dollar respectively.

[7] In view of Serbia's broadly comfortable reserve position and the need to minimise the costs of the credit arrangement with the IMF, the authorities decided not to draw the tranches in the full amount approved.

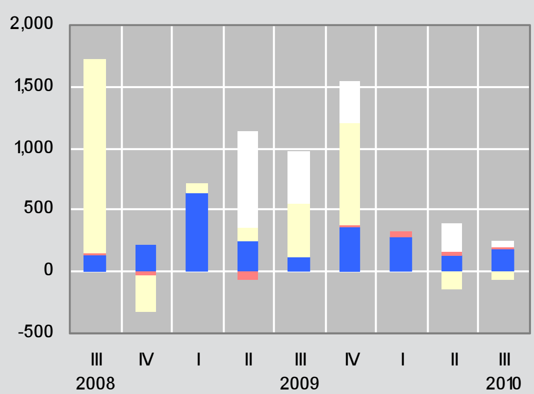
which against short-term debt, a slight increase was also recorded in their short-term borrowing in August and September. At the same time, an increase was registered in their foreign currency deposit holdings abroad. Net foreign debt repayment by enterprises was slower than in Q2, amounting to EUR 134 mln.

Chart IV.2.5 **Current account deficit and net capital inflow**
(in EUR mln)



Capital inflow did not suffice to cover current account deficit in Q3.

Chart IV.2.6 **Structure of the financial account**
(in EUR mln)



Q3 also saw a markedly modest capital inflow.

3. Capital market trends

Stock exchange indices declined mildly in Q3 despite sharp turnover contraction and shrinking foreign investor participation.

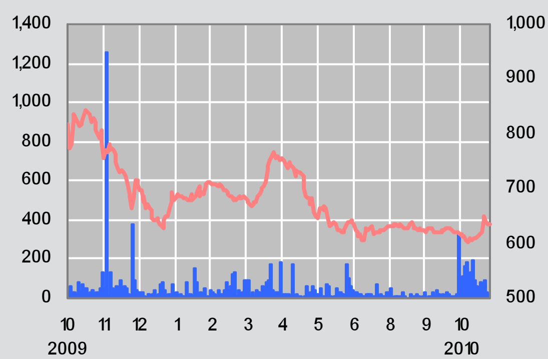
Both Belgrade Stock Exchange (BSE) indices edged down a bit in Q3. BELEX15, the index of the most liquid shares, was on a downward slope throughout the quarter (2.2%), while BELEXline, the benchmark index, slipped only in September and lost 0.9% relative to end-Q2.

The stock market liquidity squeeze persisted in Q3. Total turnover touched its new quarterly low – it plunged to RSD 4.2 bln, down by 10.7% from Q2. This was partly due to shrinking foreign investor participation – in total stock trading worth RSD 2.7 bln, foreign investor share was 36.2% and net stock purchases mere RSD 49 mln.

Of total turnover, RS bonds accounted for as much as 35.5%. Most traded were the shortest maturity bonds – A2011 (RSD 355.8 mln) and A2012 (RSD 338.8 mln). The yield until maturity lost 40 bp relative to end-Q2, reaching by end-September around 3.3% p.a. The highest yield was recorded on bonds maturing in 2011.

The BSE market capitalisation totalled RSD 934.3 bln by end-September, up by RSD 80.8 bln on end-Q2, mainly due to the listing of shares of the Serbian Oil Industry (NIS) (RSD 75 bln on 30 September), and to

Chart IV.3.1 **Belex 15**



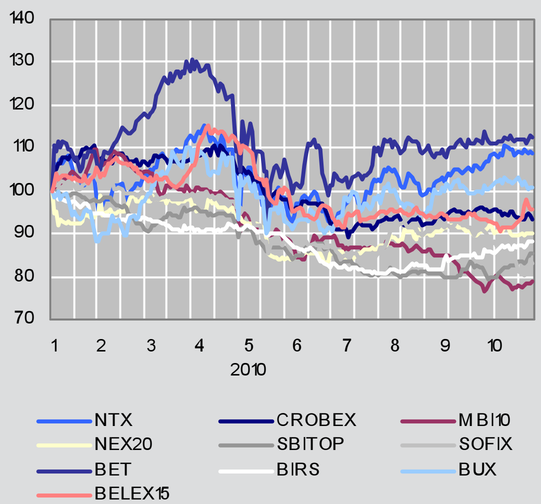
Source: BSE.

Belex15 continued to display negative movements in Q3, while a drop in turnover was accompanied by a negligible change in the index value.

bond price hikes (up from RSD 162.2 bln at end-Q2 to RSD 168.8 bln in September).

BELEXsentiment rose to its highest six-month figure of 118.6 index points in October. Still, despite positive expectations of market players, October saw a modest hike in stock prices. Namely, BELEXline picked up by 2.1% to 1,252.0 index points, whilst BELEX15 rose by 2.4% to 635.5 points. Stock market liquidity improved in October – total trading came at RSD 3.8 bln.

Chart IV.3.2 **Stock exchange indices across the region**
(in index points, normalised, 31. 12. 2009 = 100)



Volatility of stock exchange indices in the region continued in Q3.

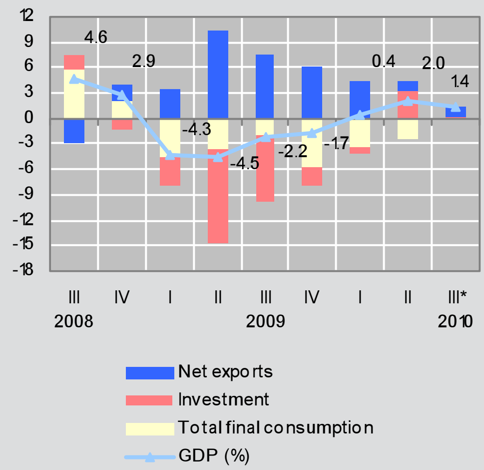
Regional stock exchange indices were rather volatile in Q3. The Bucharest (BET) and Budapest (BUX) ones rose most – 12.5% and 10.4% respectively. In addition to BSE indices, Ljubljana (SBITOP) and Skopje (MBI10) benchmark indices tumbled as well (5.6% and 14.0% respectively).

4. Aggregate demand

The recovery in domestic demand in Q3 came in response to higher private consumption and investment. At year level, the strongest contribution to economic growth is expected from export demand.

Seasonally-adjusted, estimated GDP growth slowed down in Q3 (0.6%), while domestic demand picked up by 1.2%. Positive contributions to quarterly GDP growth came from household spending (1.7 pp) and private investment (2.4 pp), and negative from changes in stocks (-3.0 pp) and net exports (-0.8 pp).

Chart IV.4.1 **Contribution to y-o-y GDP growth**
(in percentage points)



* NBS estimate.

Lower government spending and investment in Q3 contributed to the slowdown in GDP growth.

Y-o-y, both GDP and domestic demand are estimated to have experienced slower growth in Q3 (1.4% and 0.2%, respectively). The rise in domestic demand slackened as a result of declining government spending and investment. Domestic demand added 0.2 pp and net exports 1.2 pp to y-o-y GDP growth.

The projection of 1.5% GDP growth in 2010 stated in the last Report remains unchanged. Growth will be driven by export demand (net exports – 2.2 pp contribution), while in contrast to the previous year, investment will increase modestly, providing a 0.5 pp contribution. The impact of final consumption on economic activity will remain negative (-1.2 pp). The key boost to economic growth in 2011 (3–3.5%) is expected from investment, and to a smaller degree, from final consumption and net exports.

Domestic demand

Household spending

Quarterly growth in retail trade turnover points to an increase in household spending relative to Q2.

Seasonally-adjusted, household spending is estimated to have continued up (2.3%), contributing 1.7 pp to GDP growth in Q3.

After a longer period of time, household spending is also estimated to have recorded a y-o-y increase (0.4%), adding 0.3 pp to y-o-y GDP growth.

Overall household income (wages, pensions and social transfers) declined from a quarter earlier by 1.5% in real terms, reflecting chiefly a real decrease in the wage bill (2.3%).

The volume of remittances is typically higher in the second half of the year. In Q3, their real net inflow increased by 14.3%, boosting the sources of household income.

As an additional source of spending, household lending continued up, though at a slower pace than a quarter earlier. Similar trends in lending activity were also registered y-o-y (13.1%).

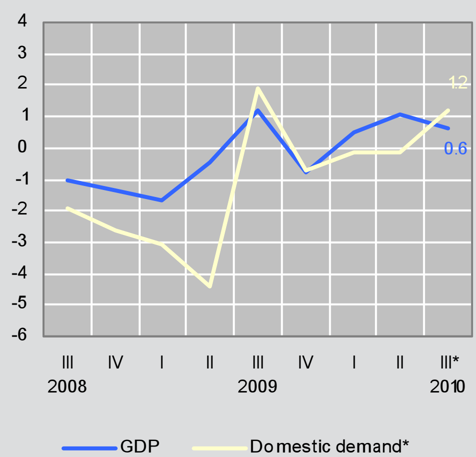
Household savings recorded a smaller real growth than a quarter earlier, which reflected on the increase in spending.

The most important indicator of household spending – retail trade turnover showed a seasonally-adjusted increase of 2.7%. More importantly, it recorded growth in y-o-y terms for the first time following a six-quarter decline. The increase in household spending against the backdrop of a real decline in wages is probably due to expectations of an increase in wages and pensions as of next year.

Turnover in the hotels and restaurants industry, as another indicator of household spending, recorded a rise in both seasonally-adjusted and y-o-y terms. On the other hand, the number of overnight stays declined from the previous quarter, while y-o-y data suggest a slowdown in the decline of this indicator.

As expected, household spending decreased in the year to September by 2.7% y-o-y. However, the recovery in retail trade turnover and growth in the telecommunications industry signal positive movements in household spending by year-end. It is expected therefore that the decline in household spending in 2010 as a whole will be much softer than a year earlier.

Chart IV.4.2 **Growth in GDP and domestic demand**
(seasonally-adjusted quarterly growth rates)



* NBS estimate.

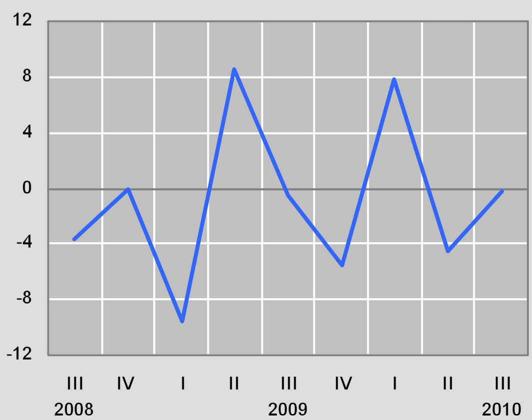
GDP growth slowed in Q3, while domestic demand showed further recovery.

Government spending

The scale of government spending in Q3 remained broadly unchanged from the previous quarter. In 2010 as a whole, it is expected to decline by around 1.9% in real terms.

Data on government outlays for the purchase of goods and services and payment of public sector wages point to a cut in government spending by 1.5% y-o-y in real terms. Seasonally-adjusted, government spending fell 0.2% from the previous quarter. In 2010 as a whole, it is expected to decline 1.9% in real terms, as a result of the freeze on public sector wages in place until January 2011.

Chart IV.4.3 **Public spending**
(seasonally-adjusted data, quarterly growth, in %)



Q3 saw a negligible drop in public spending.

Text box 3: Fiscal responsibility – introducing fiscal rules

Fiscal rules proposed by the Amendments and Supplements to the Budget System Law[1] basically amount to two caps on government spending. One limits public debt to 45% of GDP and the other restricts the medium-term consolidated fiscal deficit target to 1% of GDP p.a., while at the same time allowing for short-term deviations to accommodate a countercyclical fiscal policy. This puts Serbia on a long list of countries trying to ensure fiscal sustainability through introduction of fiscal rules.[2]

Based on the new rules, the highest permitted fiscal deficit in the current year will be determined in relation to the past year's deficit outturn, its deviation from the target, and the deviation of GDP growth rate from the potential medium-term growth rate, according to the following formula:

$$d_t = d_{t-1} – a\,(d_{t-1} – d^*) – b\,(g_t – g^*)$$

where dt is the level of fiscal deficit for the year t, g_t – the real GDP growth rate for the year t, d^* – the fiscal deficit target, g^* – potential real medium-term GDP growth rate, coefficient a – the pace at which actual deficit is nearing the target deficit, and coefficient b – the extent to which the fiscal deficit's deviation from the target is due to GDP growth rate's deviation from the potential growth rate. Coefficients a and b are set at 0.3 and 0.4 for the years to 2013, after which they will be determined for the next three years.

The aim is to eliminate 30% of the fiscal deficit's deviation from the previous year's target, yearly, and to adjust its level to the overall state of the economy (as fiscal deficit tends to be higher than planned in times of recession, and lower or going into surplus in times of expansion). Following the above Amendments and Supplements, potential medium-term GDP growth rate is set at 4% for each year until 2014. In later years, potential medium-term GDP growth rate will be set by the Fiscal Council. To ensure fiscal consolidation, the Amendments and Supplements also define a set of fiscal rules focusing on the reduction of current rather than of capital expenditure.

According to the regulations of the European Commission, which calculates the Fiscal Rule Strength Index (FRSI) for each member state, there are five criteria determining the strength of a fiscal rule: statutory base of the rule, nature of the body in charge of monitoring respect of the rule, nature of the body in charge of enforcement of the rule, enforcement mechanisms of the rule (correction and sanction mechanisms in case of non-compliance), and media visibility of the rule. The FRSI score also depends on the coverage of the rule, meaning that the rule will be assessed as stronger if it relates to general government rather than to central or local government.

The proposed fiscal rules are based on a legal act and would therefore score high on the first criterion. The monitoring of fiscal rule enforcement in Serbia is entrusted to the Fiscal Council, which is an independent authority and, as such, represents an optimal solution by the European Commission standards. The proposed amendments envisage a correction mechanism in the event of non-compliance with prescribed fiscal rules (and principles) to the effect that the government is obliged to submit a report to the National Assembly specifying the reasons for non-compliance and the timeframe for the correction. On the other hand, the non-compliance sanction mechanism remains vaguely defined. As regards media visibility, the National Assembly sessions are open to the public and the Fiscal Council is legally mandated to provide the Assembly with analyses and opinion on Fiscal Strategy Report and Budget Law drafts, meaning that the enforcement of fiscal rules will be open to media coverage. Finally, the strength of fiscal rules will be determined by the consistency of the correction process implementation and the significance the media (and the public) attach to their non-observance. Overall, enshrining fiscal rules in a legal act marks a significant step forward and will strengthen not only fiscal discipline, but contribute to the overall macroeconomic stability of the country as well.

[1] RS Official Gazette, No.73/2010.

[2] The last review of fiscal rules conducted in 2008 shows that within EU-27 only Greece and Malta had no fiscal rules in place..

Investment activity

Private capital investment picked up in Q3. Overall investment activity, however, declined further in response to plummeting stock.

Investment activity declined in Q3 (1.0%), leading to a slowdown in quarterly GDP growth (-0.2 pp).

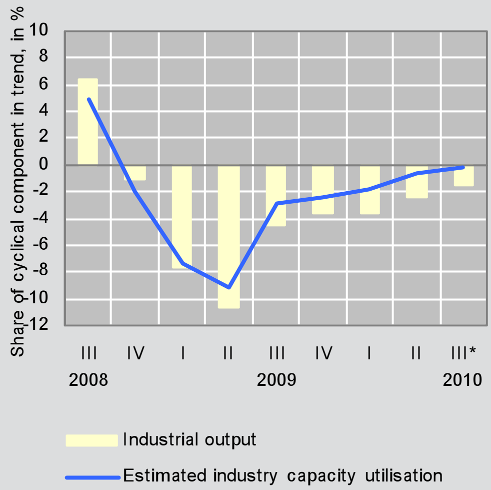
A downturn in investment was prompted by a real decline in stocking rate levels compared to Q2 (26.1%, contribution to GDP growth: -3.0 pp). By contrast, an upturn was recorded for capital investment, notably private investment, signalling a potential pick-up in economic activity. Further, a rebound in private investment was spurred by rising imports of investment goods.

Y-o-y data indicate a rise in investment activity (1.0%) and its positive contribution to GDP growth (0.2 pp). In addition, a decline in capital investment recorded a marked slowdown (0.2%) relative to Q2 (22.9%), while growth in stocks lost pace.

The y-o-y recovery in investment activity is confirmed by a slackening decline in the value of completed construction works, a smaller decline in the number of construction permits issued, and rising imports of capital goods.

Private investment rose y-o-y, but its contribution to economic activity was offset by lacklustre government investment caused by manifestly slow implementation of public investment projects.

Chart IV.4.4 **Industry capacity utilisation**
(seasonally-adjusted data)



* NBS estimate.

Industry capacity utilisation is estimated to have improved in Q3.

Though moderate, the y-o-y growth in private investment appears encouraging for the first time since the outbreak of the crisis. Such movements are likely to reflect on the future production by business entities and thus reinforce further economic recovery.

Table IV.4.1 **Investment indicators**
(y-o-y growth rates in %)

	Q3 2009 / Q3 2008	Q4 2009 / Q4 2008	Q1 2010 / Q1 2009	Q2 2010 / Q2 2009	Q3 2010 / Q3 2009
Real indicators					
Construction	-16.4	-17.3	-12.5	-11.9	-1.5 *
Industrial production of capital goods (physical volume)	-24.3	-10.3	4.5	-11.3	-11.5
Exports of capital goods**	-28.5	-18.8	-10.1	5.8	5.8
Imports of capital goods**	-25.1	-7.7	-15.9	0.3	10.6
Stocks of capital goods	-17.1	-10.8	4.3	11.4	3.6
Industrial production of intermediate goods (physical volume)	-18.5	2.9	13.7	21.5	10.2
Exports of intermediate goods**	-42.3	-2.2	35.7	57.2	49.9
Imports of intermediate goods**	-17.0	-0.1	9.7	23.0	34.2
Stocks of intermediate goods	-5.4	-1.8	-1.0	-1.4	-1.8
Government investment spending**	-20.4	-21.3	-31.8	-35.0	-11.4
	2009		2010		
Financial indicators	Q3	Q4	Q1	Q2	Q3
Medium- and long-term external borrowing by enterprises (net, in EUR mln)	-114.0	-35.4	-77.0	-275.6	-136.0
Short-term credits to entreprises (in RSD bln)	8.8	-1.8	32.5	39.4	19.7
Long-term credits to enterprises (in RSD bln)	10.7	35.4	16.1	35.8	12.3
Long-term credits to households (in RSD bln)	4.2	20.9	23.9	43.8	22.8

* NBS estimate.
** Imports are deflated by the index of producer prices of manufactured products in Germany; Exports are deflated by export producer prices of capital goods; Government investment spending is deflated by the index of producer prices of manufactured products.

As shown by the cyclical component of labour productivity in industry, industrial capacity utilisation improved significantly in Q3, serving as a one more indicator of investment recovery.

Net external demand

Worsening net exports took a heavy toll on seasonally-adjusted GDP movements. The imports structure signals a potential pick-up in economic activity.

Seasonally-adjusted, import growth outpaced exports. The increase in foreign trade deficit led to a slowdown in economic growth. The contribution of net exports to GDP growth is estimated at -0.8 pp.

In y-o-y terms, however, foreign trade had a positive impact on GDP movements (1.2 pp). Commodities exports continued to rise faster than imports (24.9% vs. 17.4% y-o-y), which can be largely attributed to the effects of real depreciation of the dinar. Base metals (c. 7.5 pp) and chemical products (c. 5.0 pp) accounted for an important portion of exports.

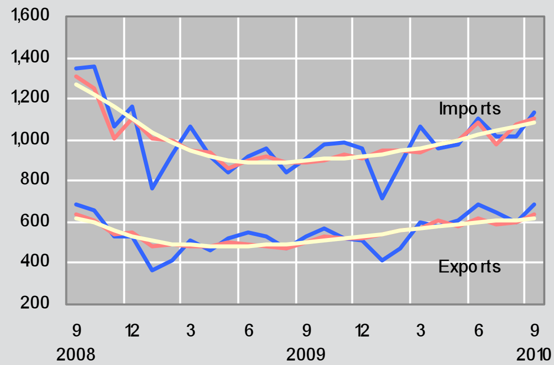
Food was another driver of export growth in Q3. Namely, despite this year's bad weather conditions and lower agricultural yields, the exports of agricultural products (primarily corn, raspberries and sugar) and processed food went up. This growth is likely to step up as Serbia is soon to start freely exporting fermented pork products (processed meats) to the EU and Russia.

Production inputs and equipment, notably intermediate goods, were dominant in the imports structure, signalling possible acceleration of economic growth in the coming period.

The above trends resulted in a 7.3% higher trade deficit y-o-y. This year is likely to witness real growth in exports and imports of c. 17% and 5% respectively, providing the key impetus to economic recovery (2.2 pp contribution to GDP growth).

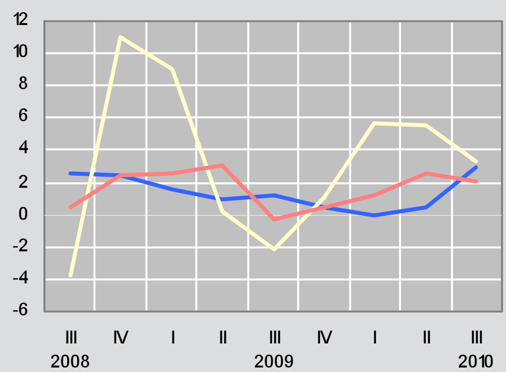
Imported inflation[8] declined relative to two earlier quarters and reached 12.7% at the annual level[9]. This was due to a 0.2% fall in EU and US prices (on average, p.a.) and weaker depreciation of the nominal effective exchange rate of the dinar relative to Q2. A strong past

Chart IV.4.5 **Exports and imports**
(in EUR mln)



The deficit on trade in goods widened in Q3 amid faster growth in imports.

Chart IV.4.6 **Domestic and imported inflation**
(quarterly growth rates, in %)



Source: NBS and Eurostat.

The growth in imported inflation softened due to lower nominal effective depreciation of the dinar, but also due to the drop in EU and US prices.

[8] Imported inflation is a result of change in the nominal effective exchange rate of the dinar (weights: 0.8 for the euro and 0.2 for the dollar) and prices in the eurozone and the United States (weights 0.8 : 0.2).

[9] Ratio of averages of two consecutive quarters elevated at the annual level.

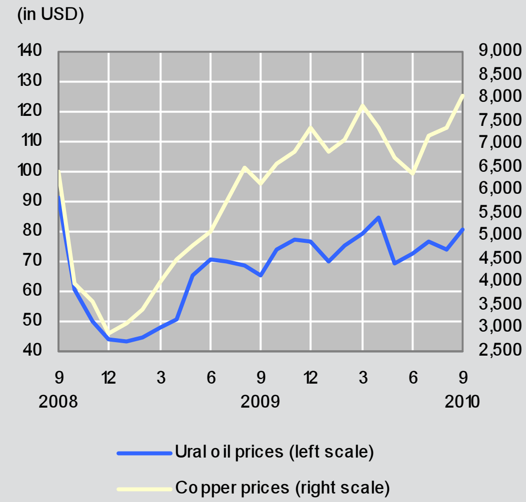
rise in imported inflation, an upswing in food prices and recovery of demand helped non-food core inflation accelerate.

The price of one barrel of crude oil in the world market remained broadly in the USD 70 to 80 range for most of Q3. By end of the quarter, however, oil prices spiralled above USD 80, reflecting the weakening of the dollar and soaring demand in emerging markets, notably in China that drives prices of most basic raw materials. The International Energy Agency is estimating a rise in oil demand in 2011 relative to 2010, while OPEC countries seem to have no dilemmas about the current oil price. They are not planning to increase their output quotas despite concerns that further price hikes could imperil the fragile economic recovery. The majority believe the current USD 70–80 range is well-balanced and that it suits everyone. The future oil price movements will hinge mainly on the value of the dollar.

The price of copper, the most significant non-ferrous metal in terms of Serbian exports, shot up by around 27%, outpacing the oil price hike during the period observed. The upswing in copper prices was prompted by the same factors that induced the oil price hike. By end-September, copper prices hit the year's record high, outstripping USD 8,000 per tonne. This trend continued into the first half of October.

Grain prices surged in 2010, particularly from mid-summer, owing to severe drought conditions and the ensuing wildfires in Russia and Ukraine. In Russia, the world's fourth largest wheat exporter, this summer's harvest fell 25% below expectations, inducing it to ban wheat export until the end of 2011. Rising wheat prices drove an upsurge in other grain prices as well, notably corn, soy and rape seed. Meat prices displayed the same dynamics, touching their record high for the last 20 years. This has provoked fears of a repeat of the global food crisis that swept across the world two years ago. Such fears are further buttressed by the announcement of the US Department of Agriculture that corn production in the US will show a decline by 4% in 2010, which provoked an 8.5% rise in corn prices in the course of one day only. As world production of cereals is concentrated in several large countries, any supply-side disturbances, either in regard to Russian wheat or American corn, will inevitably have a global impact.

Chart IV.4.7 **Oil and copper price movements**



Source: Bloomberg.

Oil prices were broadly stable in Q3. Copper prices displayed a marked upward trend throughout the quarter.

5. Economic activity

Economic growth softened in Q3, but the negative output gap is slowly narrowing.

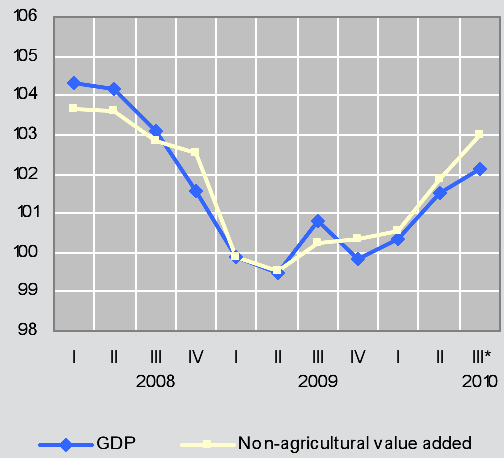
Following y-o-y acceleration in Q2 (2.0%), GDP growth is estimated to have slowed in Q3 (1.4%[10]). A slowdown in growth is also signalled by the decline in seasonally-adjusted GDP growth from 1.1% in Q2 to 0.6% in Q3. Seasonally-adjusted growth in NAVA (non-agricultural value added) is forecast at 1.1%, i.e. close to its pre-crisis level.

A slowdown in economic growth was driven mainly by a slack in agricultural production. Unfavourable weather conditions reflected most severely on fruit and vegetable growing and wheat production. A decline in agricultural production is estimated at 5.1% in Q3, contributing -0.5 pp to GDP growth.

The major contribution to quarterly GDP growth stems from rising industrial output (0.4 pp) and trade turnover (0.2 pp).

[10] RSO estimates a higher figure (2.1%) based on a smaller decline in agricultural output.

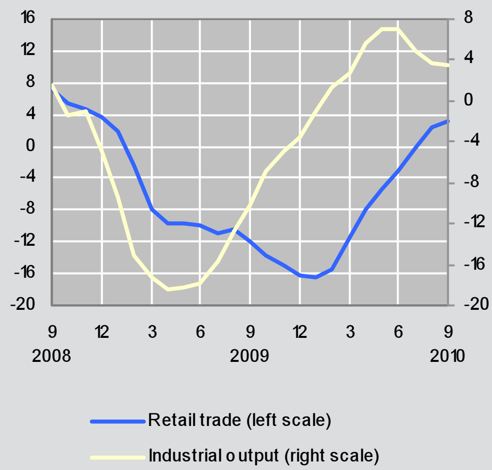
Chart IV.5.1 **Economic activity indicators**
(seasonally-adjusted data, 2009 = 100)



*NBS estimate.

GDP growth slowed in Q3 mainly in response to faltering agricultural output.

Chart IV.5.2 **Quarterly moving averages of industrial output and retail trade**
(y-o-y rates, in %)



Retail trade recorded a y-o-y rise, while growth in industrial output slowed.

Overall industrial output rose 2.5% in quarterly terms, chiefly in response to a pick-up in manufacturing (2.6%), driven by an increase in the production of food, beverages, coke and petroleum products. The mining and quarrying sector recorded a 5.8% rise.

Recovery in the trade sector, initiated a quarter earlier, continued into Q3, though at a weaker pace (1.6% in Q3 vs. 3.1% in Q2, seasonally-adjusted).

A vigorous rebound was noted in the hotels and restaurants sector (15.0%) but contributed little to overall economic growth (0.1 pp) due to its low share in GDP structure. A slowdown in lending resulted in somewhat weaker growth in the financial intermediation sector (1.5% in Q3 vs. 1.8% in Q2).

Estimates point to recovery in the construction sector that rose 3.6% in quarterly terms. Such recovery was also fuelled by rising government capital expenditure.

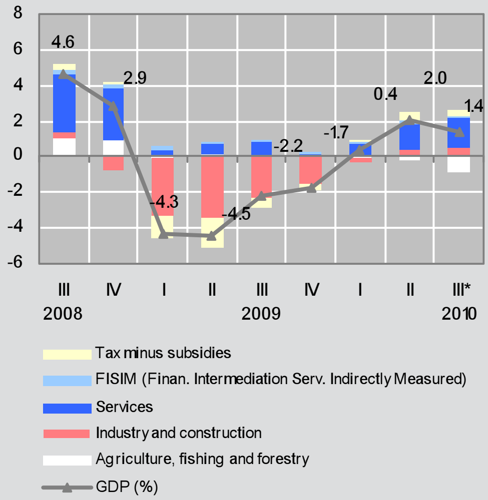
In y-o-y terms, expectations of a slowdown in GDP growth (1.4%) were prompted by high last year's base and a y-o-y 7.0% decline in agricultural output (contribution to GDP growth: -0.8 pp). The sharpest fall is expected with the production of wheat, apples, plums, potatoes and beans. In contrast, the production of corn, soy, sunflower and rape seed is expected to bounce back.

The strongest contribution to y-o-y GDP growth is likely from the transport and communications sector (0.9 pp), overall industrial output (0.6 pp) and wholesale and retail trade (0.3 pp).

Within transport and communications, telecommunications are expected to provide the strongest boost to y-o-y growth.

Following acceleration in Q2, growth in overall industrial output is estimated to have slackened in Q3 (3.7% y-o-y), in response to sluggish growth in manufacturing caused by faltering production of base metals. A rise in manufacturing was aided by the production of chemicals and chemical products, food, coke, petroleum products, machinery and apparatus. The mining and quarrying sector recorded a 10.9% rise, but contributed 0.1 pp to GDP growth. On the other hand, a 3.5% decline in the production of electricity, gas and water gave a negative contribution to GDP growth (-0.1 pp).

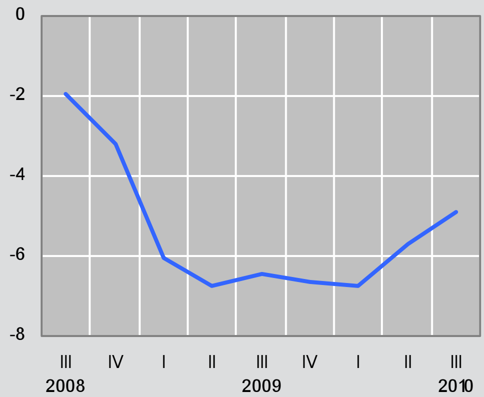
Chart IV.5.3 **Contribution to y-o-y GDP growth**
(in p. p.)



*NBS estimate.

Slower economic recovery is expected in Q3.

Chart IV.5.4 **Output gap***
(percentual deviation from the trend)



*NBS estimate.

Though economic recovery slowed in Q3, the negative output gap is narrowing.

A slump in construction is estimated to have decelerated sharply in Q3 (-1.5% y-o-y), as indicated by a pick-up in the production of non-metal mineral products, mining of non-metal ores and quarrying, but also by a slower decline in government investment activity.

Y-o-y growth accelerated in the trade sector – 2.9% (0.3 pp contribution to GDP growth), on the back of rising retail trade turnover. The hotels and restaurants sector is expected to record growth for the first time since end-2008 (0.4 y-o-y in Q3), mainly in response to rising turnover in the catering industry.

In view of the past developments and future expectations, we did not revise the economic growth figure for 2010 (1.5%). Growth is likely to accelerate in 2011 (3% – 3.5%).

Economic activity measured by NAVA signals gradual narrowing of the output gap. This implies not only continuation in disinflationary pressures due to the still depressed aggregate demand, but their gradual weakening as well.

6. Labour market developments

Wages

Real wages contracted in Q3 and unit labour costs in the industry continued down.

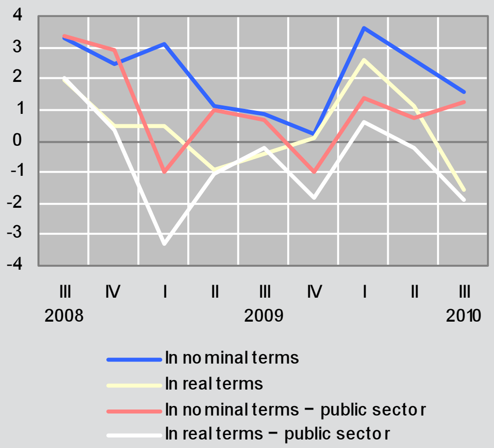
Seasonally-adjusted growth in nominal wages slowed further in Q3, while real wages declined q-o-q. Nominal net wages rose by 1.6%, whereas real wages dropped by the same percentage.

Y-o-y data indicate further growth in nominal (8.3%) and a slowdown in real wages (2.2%). Judging by original data, the average net wage amounted to RSD 34,372 in Q3.

Quarterly growth in nominal net wages slowed in the majority of sectors. The major fall was recorded in the electricity production sector that experienced a downfall in overall activity in Q3. A pick-up was recorded for agriculture, transport, finance and the hotel industry.

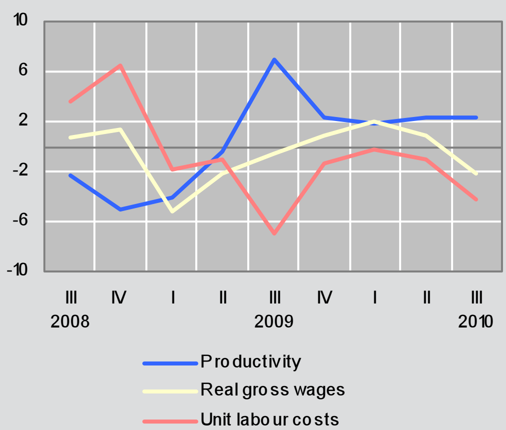
Public sector nominal wages rose by 1.2% seasonally-adjusted, while real wages contracted further by 1.9%. In

Chart IV.6.1 **Average net wages – total and the public sector**
(seasonally-adjusted data, quarterly growth, in %)



In Q3, public sector real wages recorded a faster decline than total wages.

Chart IV.6.2 **Movements in productivity, real gross wages and unit labour costs in the industry**
(seasonally-adjusted data, quarterly growth, in %)



Slower growth in industrial production and a decline in real gross wages provoked a further fall in unit production costs.

y-o-y terms, public sector wages gained 2.5% in nominal and lost 3.3% in real terms. The steepest real decline was recorded in public state-run companies, educational, health care and social welfare sectors.

As labour productivity in the industry remained broadly unchanged and real gross wages declined further, unit labour costs experienced a further seasonally-adjusted drop. A decrease in unit labour costs in manufacturing was smaller, reflecting a milder fall in real gross wages.

Public sector wages and pensions will be raised in early 2011. The Government's decision to lift the freeze on public sector wages and pensions in January instead of April 2011 is particularly important from the aspect of domestic demand and inflation. Reflecting a rise in productivity, wage growth is likely in the private sector as well. However, as the unemployment rate looks set to remain high despite some economic recovery, household spending will rise slowly.

Employment

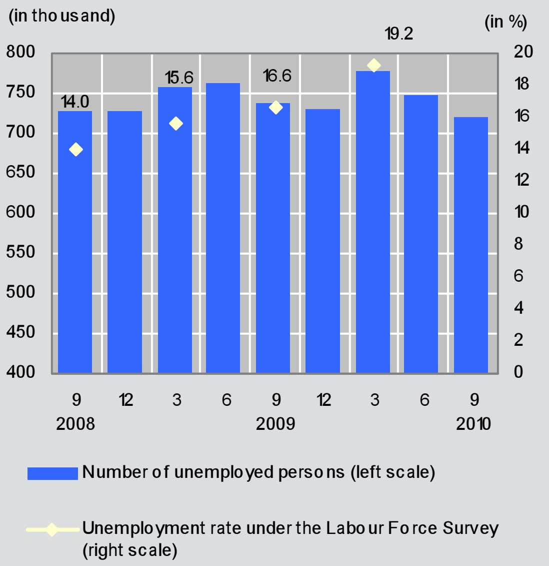
Employment contracted further in Q3. However, owing to the recovery of industrial output, the negative contribution of industrial sector employment is narrowing.

Findings of the Labour Survey point to a further drop in employment relative to Q2 (by 8,187 or 0.5%). A y-o-y fall came at 3.4%, as a result of shrinking employment by entrepreneurs and in the manufacturing sector. Since the outbreak of the crisis, the heaviest job cuts (both in relative and absolute terms) were made by private entrepreneurs. Though considerable, the negative contribution of industrial sector employment is narrowing owing to the recovery of industrial output. A y-o-y rebound was recorded only in the mining and quarrying sector, real estate activities, and to a slight extent in the sector of electricity and gas production.

Broken down by activity, the highest employment in the period to end-September was recorded with entrepreneurs (25.3%), followed by the sector of services (24.0%) and the public sector (23.4%).

Total public sector employment slackened somewhat both in y-o-y (0.3%) and q-o-q (0.6%) terms. The sharpest

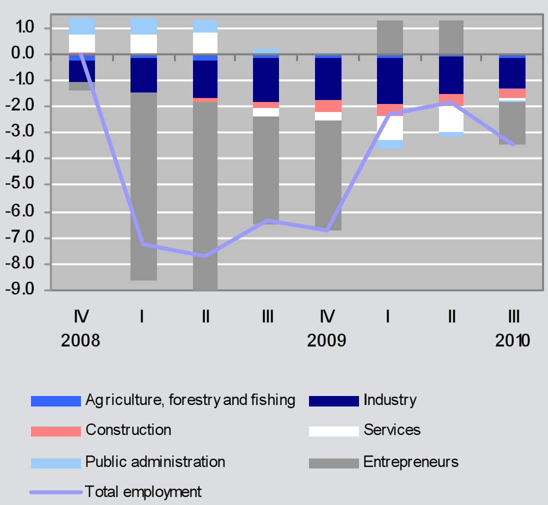
Chart IV.6.3 **Unemployment**



Source: National Employment Service and Serbian Statistical Office.

The number of unemployed persons declined in Q3.

Chart IV.6.4 **Employment by sector**
(contribution to y-o-y growth in employment, in p.p.)



Source: Statistical Office.

Q3 experienced a drop in employment, most notably in the manufacturing and entrepreneurial sectors.

downturn was noted in the public administration and utilities companies. However, public sector employment exceeded the pre-crisis average, mainly due to rising employment in the educational and health care sectors.

The number of unemployed persons registered by the National Employment Service has been on a decline since early 2010. This, however, is not only the reflection of real economic trends, but of the deletion from records of job seekers failing to report regularly to the National Employment Service. In September, official unemployment reached 721,000, down by 26,000 from June. At the same time, the number of newly recorded job seekers rose from Q2.

Though efforts to stave off negative trends in the labour market failed yet again, growth in new employment and an increase in advertised vacancies relative to Q2 give reason for some optimism.

7. International environment

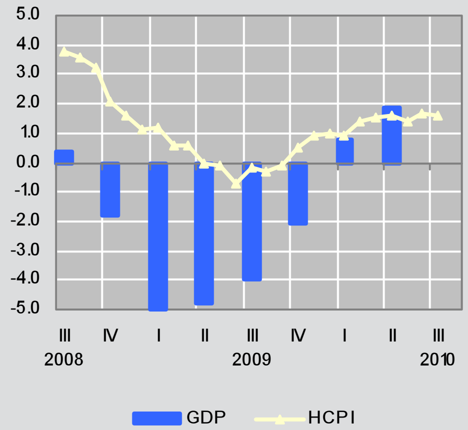
Though the global economic recovery still lacks in strength and proceeds unevenly across countries and regions, there is no risk of a major relapse. Growth prospects for Serbia's key trading partners are solid.

Still insufficiently strong and unevenly distributed across countries and regions, the global economic recovery is continuing in the second half of the year. The recovery is faster in economies with stronger pre-crisis fundamentals and smaller output losses during the crisis. Downside risks to economic growth remain elevated in view of the global imbalances and a possible synchronised withdrawal of stimulus programmes. Nonetheless, a major slowdown appears highly unlikely. Monetary stimuli remain in force and most economic analysts argue in favour of their prolonged use until economic growth takes hold. Stabilisation measures taken by European governments to consolidate public finance and restore investor confidence are on track and already yielding results, evident primarily in the euro area.

In 2010 and 2011, the global recovery will be led by developing Asian economies, notably India and China. Robust economic activity of these two countries is sustained by rebounding exports and bolstered domestic demand. Strong import demand from China, especially demand for raw materials, equipment and capital goods, is helping power growth in most countries of the Asian region, which is experiencing a revival in capital inflows.

The recovery of the US economy continues on the back of unprecedented fiscal and monetary policy stimulus packages. However, growth moderated from 3.7% in Q1 to 1.6% in Q2, and is not expected to step up before the year ends. Preliminary estimates place third quarter growth at 2%. Much of the weakness of this recovery reflects sluggish personal consumption, high unemployment, fallen asset prices and bank reluctance to lend to heavily indebted citizens. Yields on long-term Treasury bonds have recently fallen significantly amid increased purchases by investors seeking a safe haven, and Fed's determination to extend its asset purchase programme. Financial markets have already adjusted to the Fed's recent decision to buy USD 600 bln worth of Treasury bonds by mid-2011. No exit strategy is on the table, but the public is being reassured that instruments for mopping up excess liquidity are available and will be used when the time comes.

Chart IV.7.1 **Eurozone GDP and inflation**
(y-o-y growth rates)



Source: Eurostat.

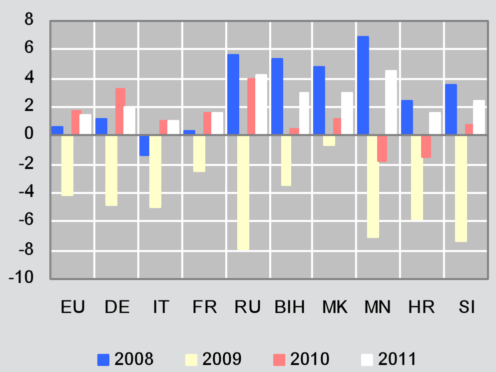
GDP growth, begun in Q1, accelerated in Q2. Inflationary pressures remain in check and inflation growth negligibly small.

The recovery in the euro area is moderate and uneven. Germany, on the one hand, is leading the recovery thanks to its vigorous exports, but on the other hand, some highly indebted countries are recording a rather modest growth or even an economic decline. Such divergence in growth trends represents a major stumbling block in the path of a common monetary policy.

Establishing public debt sustainability is on the top of advanced economies' agenda and an array of fiscal adjustment measures have been taken to that effect. Despite positive stress test results, eurozone banking systems remain vulnerable and highly reliant on ECB's financing facilities. From the very start of the crisis, ECB has been providing unlimited collateralised loans to banks at the policy rate. However, it seems likely that the ECB will revert to regular auctions already in January 2011. In advanced Europe inflation remains low because output gaps are large, and inflation expectations are well anchored. It is therefore expected that the ECB policy rate will stay unchanged throughout this and the next year and that non-standard monetary support measures will be wound up gradually.

Eurozone economic growth prospects for 2010 and 2011 appear brighter now than they did by mid-year. Considering that the euro area is Serbia's most important trading partner, chances for increasing domestic exports seem most promising. Nevertheless, the extent of this increase will largely depend on exporters' capacity to

Chart IV.7.2 **Serbia's key foreign trade partners - GDP growth rates and their projections**
(in %)



Source: IMF, WEO, October, 2010.

The recovery of the above economies in 2010 and 2011 is expected to be strong enough to spur growth in our exports.

adjust to the growing competition from emerging markets, as well as on the sustainability of eurozone recovery.

Emerging Europe is recovering better and faster than the euro area. Forecasts of economic growth for these countries also improved relative to figures released in the first half of the year. Economies that experienced the mildest downturns (Poland), and others that faced the crisis with relatively strong household and bank balance sheets (Turkey), are projected to continue growing at a faster pace than those that experienced unsustainable public and private consumption boom pre-crisis. The difference in the dynamics of economic growth is due to the fact that pre-crisis imbalances run by the latter have tightly constrained the room for macroeconomic policy manoeuvre. Of Serbia's trading partners, CEFTA countries need to be singled out – their growth prospects for 2011 are quite solid, which is very important, not least because of the growing trade surplus Serbia has been recording with them since the start of the year. Monetary policy in Central and East European countries is expected to remain expansionary for some time. A gradual increase in policy rates is most likely in 2011.

Following a months-long slide, the euro picked up against the US dollar from July 2010. The strengthening was most pronounced in September and early October, when the exchange rate reached 1.39 USD/EUR. A relatively sharp weakening of the dollar is attributable primarily to investor expectations of another round of Fed's quantitative easing through the purchase of Treasury bonds. Such a move on the part of the Fed normally leads to an increase in prices of Treasury bonds and weighs down on dollar securities' yields. Quite expectedly, investors turn to higher-yielding securities. In addition, the dollar weakened against the euro as the euro area recorded stronger growth in Q2 than the United States and market players developed expectations that such trends would continue into Q3. Another contributory factor was greater investor confidence in the implementation of austerity measures by the governments of Greece and other debt-ridden eurozone countries. Increased confidence led to the narrowing of spreads on their sovereign bonds relative to the ten-year German benchmark bond. The spread on Greek government bonds of the same maturity plunged to 700 basis points, its lowest level since June. Clearly, confidence in eurozone public finance sustainability is coming back and investors are ready again to invest into higher-yielding securities.

V. Inflation projection

Inflation will overshoot the target tolerance band in Q4 2010, but we expect it to retreat within the band by end-2011. In the coming period y-o-y inflation growth will be driven by strong pressures on food prices, past depreciation of the dinar and the rise in pensions and public sector wages anticipated in January 2011. Economic activity is expected to grow faster in 2011 and 2012 than in the last two years. The National Bank of Serbia will probably continue raising its 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 both as a range for the CPI and as a central projection rate. This projection presumes an active monetary policy which aims to keep inflation within the target tolerance band in the medium run and thus fulfil its principal role as defined by the current monetary policy framework.

Initial conditions

Due to bad weather conditions and surging global prices of primary agricultural commodities, food prices recorded a hefty rise in the period since the last *Inflation Report* and practically cast off their role of a disinflationary factor dating back to late 2008.

Sparked mainly by food prices, headline inflation increased substantially in Q3 and returned within the target tolerance band after lingering below it throughout the first half of the year. Past depreciation of the dinar also played a role and added to inflation through the rise in import prices.

The depreciation gap of the real exchange rate (indicating the drop in net importers' profit margins) widened in Q3 under the continuing impact of the past depreciation of the dinar, and could be a significant inflationary factor in the period ahead.

Inflation expectations edged up over the past several months in response to rising inflation, and will, to some degree, push up inflationary pressures in the coming period.

As indicated by the narrowing of the negative output gap (demand-side measure) in Q2 and Q3, demand continued producing disinflationary pressures in Q3, though much weaker than in early 2010 and throughout 2009.

GDP growth slowed in Q3 amid poor agricultural performance. Non-agricultural value added, however, kept growing at a brisk pace. By contrast to the prior period, economic growth in Q3 was largely driven by domestic demand – private sector spending and investment.

The eurozone, our main trading partner, registered a pick-up in economic activity in Q3 despite tighter fiscal policies.

Though the key policy rate was raised from 8% to 9% in Q3, the monetary policy stance was more expansionary than in Q2 primarily due to continued widening of the depreciation gap. Another upward revision of the key policy rate took place in October (9.5%). The full effect of the above rate increases will be felt in the coming period.

Projection assumptions

Based on their current movements and the announced revisions, regulated prices in 2010 are expected to level off slightly above the planned growth range of 9±2%. The projection assumes that the government will adhere to its plan for regulated price growth in 2011 and 2012 set at 7±2% and 6±2%, respectively.

Table V.0.1 **Projection assumptions**

	2010	2011
External assumptions		
EU inflation (Q4 to Q4)	1.8%	1.5%
ECB policy rate (year-end)	1%	1.25%
Euro area GDP growth	1.6%	1.5%
Ural oil price per barrel (year-end, USD)	86	90
Internal assumptions		
Regulated prices excl. petroleum products (Dec to Dec)	11.5%	8.0%
Prices of agricultural products (Dec to Dec)	20.0%	0.0%
Trends		
Appreciation trend of the real exchange rate (average)	1.4%	1.9%
Real interest rate trend (average)	5.30%	4.80%

As they are currently rather high, assuming average agricultural performance in 2011, agricultural product prices should grow at a slower pace than other prices in the medium term.

The trend of price convergence to the eurozone (real appreciation of the dinar against the euro) is expected to step up with the waning of the crisis. Further out, the strengthening of investor confidence in South East European markets is likely to push the risk premium down, which should together with the appreciation trend rise induce a gradual decline in the real interest rate trend.

Following strong expansion in Q2, boosted by net exports, the eurozone economy is poised for a more moderate growth in H2. Signals suggesting that its recovery is sustainable are increasing despite announced fiscal tightening in most member states. Fiscal austerity programmes will probably put off upward revision of the ECB policy rate until end-2011. Eurozone inflation in 2011 is forecast below 2%.

Inflation projection

Inflation will overshoot the target tolerance band in Q4, but should retreat within it by end-2011 (Chart V.0.1).

High monthly inflation rates will be sustained in the remainder of the year, which will, together with the low base (low inflation rates last year), cause y-o-y inflation to rise above the upper end of the target tolerance band. Inflation will accelerate on the back of continuing processed food price increases as the effects of higher input costs (prices of corn, wheat…) were not fully exhausted in Q3. Price growth will also be aided by the lag effects of the growth in import prices triggered by the dinar's depreciation May–July.

In the medium run, though to a lesser degree than before, price growth will be held back by depressed aggregate demand. As the economy recovers, the negative output gap will narrow, i.e. demand-side disinflationary pressures will grow weaker. The rise in domestic demand will be supported by the announced unfreezing of pensions and public sector wages in January 2011.

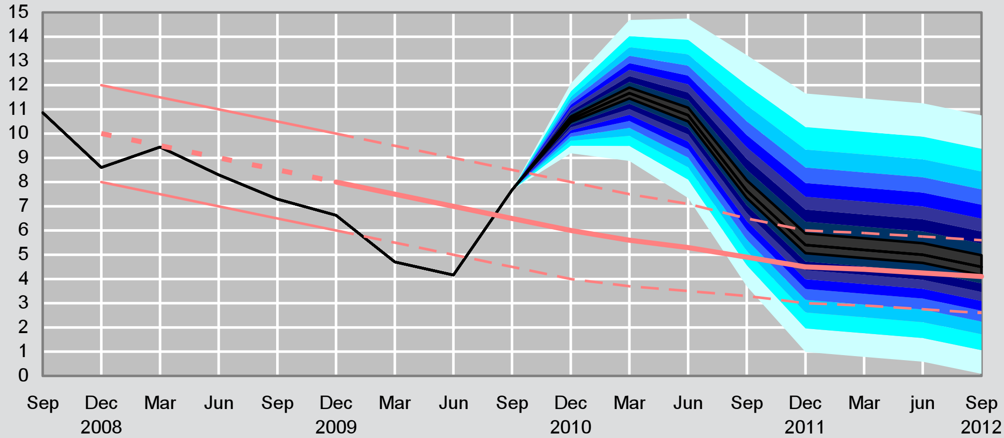
The drop in net importers' profit margins, i.e. widening of the depreciation gap during the last year, will remain an important factor affecting inflation in 2011. However, as the depreciation gap could close relatively soon given the inflation rates expected over the coming several months, the impact of this factor could prove strong, but short-lived.

Additional pressure on prices is anticipated from the rise in inflation expectations. Namely, y-o-y inflation growth, triggered by surging food prices, might tempt business entities to automatically expect higher inflation rates in the future, giving rise to new pressures on prices (i.e. second-round effects).

On the other hand, prices of food might work in the opposite direction next year. As they are currently rather high due to poor agricultural season in Serbia and worldwide, it would be logical to expect that they will decline in 2011 relative to other prices even in the event of an average agricultural performance.

Overall, however, inflationary factors are prevailing. Inflation is therefore is expected to move above the target tolerance band for most of 2011, and to fall back within it by year-end. It is important to note that high monthly inflation rates recorded in H2 2010 will reflect on y-o-y

Chart V.0.1 **Inflation projection**
(y-o-y rates, in %)



Inflation will move above the upper bound of the target in Q4 2010, but is expected to return within the target band in late 2011.

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%.

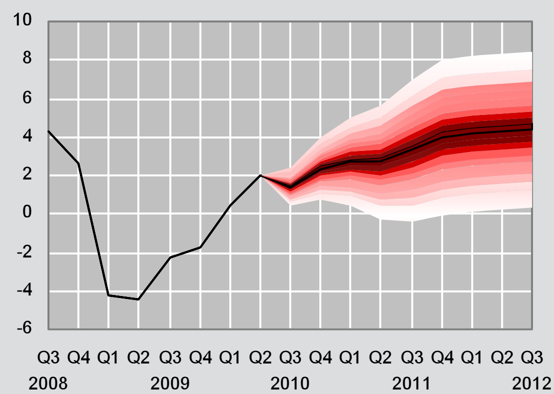
inflation rates up to twelve months ahead, which is why a perceptible drop in y-o-y inflation rates is not likely before H2 2011.

Serbian economy is poised for moderate growth (Chart V.0.2). Following 1.5% growth this year, the economy is expected to step up in 2011 to 3.0–3.5%.

Past depreciation of the dinar against the euro and currencies of CEFTA countries will continue to serve as a fillip to Serbian exports and to encourage the substitution of imports with domestic products. On the other hand, the economic recovery and rising domestic demand will lead to an increase in imports, which is why the overall contribution of net exports to economic growth will be somewhat lower than in the prior period.

Conversely, domestic demand is expected to provide a stronger contribution to economic growth than before. This refers primarily to capital investment, which suffered a sharp decline in 2009 and 2010, but is expected to pick up in the near future as the businesses' perception of growth prospects brightens. If they do take place, major investments, such as the one by FIAT and related producers, could contribute 2–3 pp to GDP growth over the two-year horizon.

Chart V.0.2 **GDP growth projection**
(y-o-y rates, in %)



GDP growth is expected to be faster in 2011 and 2012 than in the prior period.

The economy is on the mend, but the unemployment rate is likely to stay high, holding back personal consumption despite the announced unfreezing of public sector wages.

A higher GDP growth rate in 2011 will also be sustained by the low agricultural production base. Namely, after a poor agricultural season this year, agricultural output will increase next year even in the event of an average agricultural performance. Besides, high prices of agricultural products will probably encourage farmers to increase their production investments in late 2010 and early 2011.

Risks to the projection

The key risks to inflation projection are uncertainties regarding movements in food prices, inflation expectations and the risk premium.

As evidenced by current developments, inflation in Serbia is highly sensitive to agricultural shocks as food prices tend to be volatile and hold a large share in the Consumer Price Index. Uncertainties are associated with movements in prices of primary agricultural products, but also with the degree to which their growth will feed through into processed food prices. The level of domestic agricultural product prices will depend on the level of their foreign counterparts and on local weather conditions next year, both factors being subject to volatility and hard to predict.

The unfolding of second-round effects of the agricultural shock largely hinges on the future rise in inflation expectations. Experience shows that the rise in inflation expectations in response to inflation growth is quite likely. What remains uncertain, however, is the extent of the increase in expectations. A higher increase would entail stronger second-round inflationary effects, calling for a tighter monetary policy stance.

Strong impact of risk premium movements on the exchange rate and interest rates, and by extension, on the intensity of inflationary pressures, could persist in the period ahead. Over the past several months, the risk premium recorded a hefty rise on concerns over the Greek debt crisis. It appears equally possible that the situation on this front will stabilise relatively quickly as that it may take much longer to settle down.

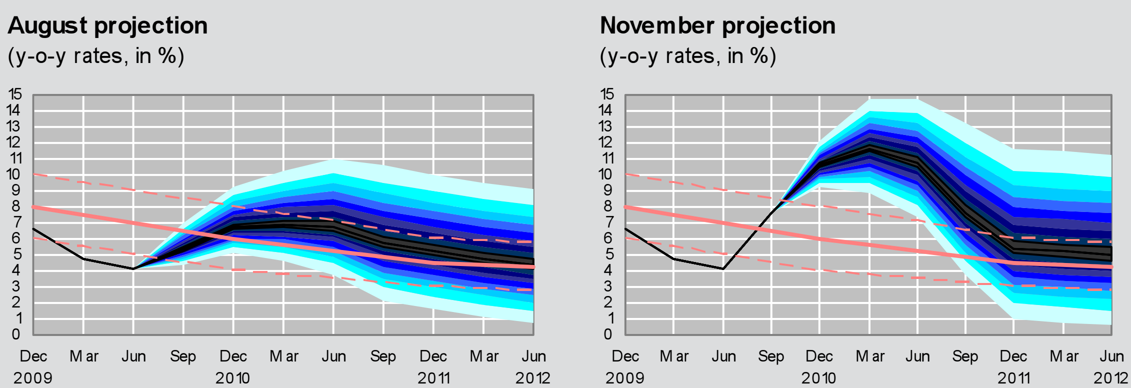
On balance, based on our best judgement, the risks to the outlook for inflation are tilted to the upside due to the possibly faster growth in food prices and stronger pass-through of dinar's depreciation to inflation.

Comparison with the previous projection

The new inflation projection is significantly higher than the one published in the August Report (Chart V.0.3) primarily because of stronger upward pressures on food prices, but also because of the government's decision to unfreeze public sector wages and pensions earlier than planned.

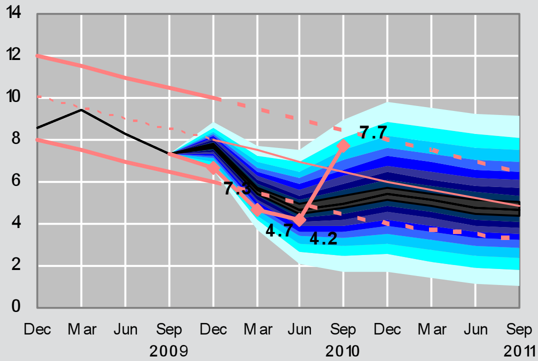
Growth in food prices in Q3 proved much stronger than anticipated in the run up to the August Report. It was particularly pronounced in prices of processed food, such

Chart V.0.3 **Current vs. previous projection**



November inflation projection is much higher than the one published in the August Report due to faster growth in food prices.

Chart V.0.4 **Inflation outturn vs. November 2009 inflation projection**
(y-o-y rates, in %)



In the last year inflation moved within the band projected in November 2009, running in September, however, well above the central projection figure.

as meat, edible oil, milk…Similar trends are likely to persist during the remaining months of the year, which will reflect directly on y-o-y inflation rate almost until the end of next year.

The government's decision to move forward the unfreezing of public sector wages and pensions from April to January 2011 is stirring up demand-side inflationary pressures. This gains particular importance in light of the fact that January income will be adjusted by CPI inflation growth recorded in H2 2010 that will turn out exceptionally high.

During the last year inflation moved within the range projected at the time of the November 2009 Report (Chart V.0.4). However, it was running below the central projection figure in late 2009 and early 2010 and high above it in September 2010. The main reason behind such deviations was the volatility in food prices, i.e. their drop in late 2009 and early 2010, and a substantial rise in Q3 2010.

Outlook for the key policy rate

Based on the current inflation projection and its underlying risks, the Executive Board of the National Bank of Serbia judges that further upward revision of the key policy rate is likely in the coming period, as well as the increase in monetary policy restrictiveness through the use of other instruments.

Table A
Indicators of Serbia's external position

	2002	2003	2004	2005	2006	2007	2008	2009	Q1 2010	Q2 2010	Q3 2010
EXTERNAL LIQUIDITY INDICATORS (in %)											
Forex reserves/imports of goods and services (in months)	4,1	4,8	3,9	6,2	9,1	7,2	5,2	9,4	9,8	8,6	7,6
Forex reserves/short-term debt	364,3	539,0	708,3	522,5	943,9	920,0	382,1	528,8	549,4	719,2	762,4
Forex reserves /GDP	13,8	16,5	16,5	24,4	38,8	33,6	24,5	35,4	34,7	34,8	32,9
Debt repayment/GDP	1,4	2,0	3,9	4,7	7,0	10,0	10,3	11,1	13,0	11,1	9,4
Debt repayment/exports of goods and services	7,0	9,0	16,4	17,7	23,5	33,2	34,0	39,1	43,8	32,9	27,5
EXTERNAL SOLVENCY INDICATORS (in %)											
External debt/GDP	58,7	55,9	49,8	60,1	60,9	59,5	63,1	75,0	76,3	77,9	76,9
Short-term debt/GDP	3,8	3,1	2,3	4,7	4,1	3,6	6,4	6,7	6,3	4,8	4,3
External debt/exports of goods and services	300,9	251,6	211,5	228,9	204,1	197,3	207,6	265,3	265,9	260,8	244,7
FINANCIAL RISK EXPOSURE INDICATORS (in %)											
Forex reserves/M1	144,8	196,3	222,0	292,1	357,0	307,6	301,4	393,4	463,2	468,8	431,7
Forex reserves/reserve money	133,3	168,9	166,9	170,8	179,9	174,3	141,1	190,5	201,7	206,8	196,8
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	59,3	63,9	73,7	73,6	81,2	85,8	86,8	73,6	77,5	83,1	84,0
MEMORANDUM: (in EUR million)											
GDP	16.028	17.306	19.026	20.306	23.305	28.785	33.418	29.967	6.743	7.428	7.870
External debt	9.402	9.678	9.466	12.196	14.182	17.139	21.088	22.487	22.943	23.456	23.115
External debt servicing	218	348	736	945	1.635	2.885	3.453	3.314	879	824	733
Central bank foreign exchange reserves	2.208	2.854	3.131	4.952	9.041	9.660	8.190	10.602	10.445	10.493	9.876
Short-term debt	606	529	442	948	958	1.050	2.143	2.005	1.901	1.459	1.295
Current account balance	-671	-1.347	-2.620	-1.778	-2.356	-5.053	-7.054	-2.084	-760	-610	-523
			Nov 2004	July 2005	Feb 2006	June 2007	March 2008	Dec 2009			
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	Standard & Poor's: BB-/stable			

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. Data are subject to corrections in line with the official data sources.
2. 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 harmonised, at the level of the IMF, for all countries. We have adjusted our financial risk exposure indicators accordingly.
3. Trade with Montenegro is registered within relevant transactions as of 2003.
4. Foreign debt repayment does not include early debt repayment.
5. GDP for 2010 as estimated by the National Bank of Serbia.
6. In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.
7. As of 01.01.2010 Statistical Office, according to UN recommendations, applies general trade system which is broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using special trade system.
8. In September 2010, the methodology of external debt statistics was changed – public sector external debt includes liabilities under SDR allocation (EUR 443.5 mln) used in December 2009, as well as the capitalised interest to the Paris Club Creditors (EUR 86.4 mln). Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 875.4 mln, of which EUR 397 mln related to domestic banks and EUR 478.4 mln to domestic enterprises).
9. Data for October are based on GDP in Q3, and those for November and December on GDP estimated for the year-end.

Table B
Key macroeconomic indicators

	2002	2003	2004	2005	2006	2007	2008	2009	Q1 2010	Q2 2010	Q3 2010
Real GDP growth (in %)	3,9	2,4	8,3	5,6	5,2	6,9	5,5	-3,1	0,3	2,0	2,7
Consumer prices (in %, relative to the same month a year earlier)[2]	14,8	7,8	13,7	17,7	6,6	11,0	8,6	6,6	4,7	4,2	7,7
Core inflation (in %, relative to the same month a year earlier)[2]	4,4	6,1	11,0	14,5	5,9	7,9	10,3	4,1	2,3	1,9	5,7
NBS foreign exchange reserves (in EUR million)	2.208	2.854	3.131	4.952	9.041	9.660	8.190	10.602	10.445	10.493	9.876
Exports (in EUR million)[3]	3.125	3.847	4.475	5.330	6.949	8.686	10.157	8.478	2.009	2.505	2.668
- growth rate in % compared to a year earlier	16,0	23,1	16,3	19,1	30,4	25,0	16,9	-16,5	8,1	17,2	20,4
Imports (in EUR million)[3)7)]	-6.387	-7.206	-9.543	-9.613	-11.971	-16.016	-18.843	-13.577	-3.214	-3.665	-3.918
- growth rate in % compared to a year earlier	27,2	12,8	32,4	0,7	24,5	33,8	17,7	-28,0	-4,4	12,5	16,1
Current account balance[4)7)]											
(in EUR million)	-671	-1.347	-2.620	-1.778	-2.356	-5.053	-7.054	-2.084	-760	-610	-523
as % of GDP	-4,2	-7,8	-13,8	-8,8	-10,1	-17,6	-21,1	-7,0	-11,3	-8,2	-6,7
Unemployment according to the Survey (in %)[5]	13,3	14,6	18,5	20,8	20,9	18,1	13,6	16,1	/	19,2	/
Wages (average for the period, in EUR)	152,1	176,9	194,6	210,4	259,5	347,6	358,4	337,9	321,5	335	324,8
RS budget deficit/surplus (in % of GDP)[6]	-4,3	-2,6	-0,3	0,3	-1,9	-1,7	-1,8	-3,2	-3,1	-3,7	-2,8
Consolidated fiscal result (in % of GDP)	-1,8	-2,4	0,8	0,9	-1,9	-2,0	-2,4	-4,3	-3,5	-3,7	-3,2
RS public debt (external + internal, in % of GDP)[6]	71,9	63,7	50,9	50,6	40,1	31,4	26,3	32,9	33,8	35,9	38,7
RSD/USD exchange rate (average, in the period)	64,70	57,56	58,44	66,90	67,01	58,39	55,76	67,47	71,38	79,93	81,49
RSD/USD exchange rate (end of period)	58,98	54,64	57,94	72,22	59,98	53,73	62,90	66,73	74,38	85,48	78,11
RSD/EUR exchange rate (average, in the period)	60,66	65,13	72,70	83,00	84,10	79,96	81,44	93,95	98,67	101,37	105,15
RSD/EUR exchange rate (end of period)	61,52	68,31	78,89	85,50	79,00	79,24	88,60	95,89	99,76	104,37	106,17
Memorandum											
GDP (in EUR million)	16.028	17.306	19.026	20.306	23.305	28.785	33.418	29.967	6.743	7.428	7.870

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) As of 1 January 2010, the Statistical Office, according to UN recommendations, applies the general trade system which is a broader concept and includes all goods entering/exiting the country's economic territory, apart from goods in transit. The Statistical Office published comparable data for 2007, 2008 and 2009. Previous years are disseminated under a special trade system.

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

Table C
IMF's projection for key macroeconomic indicators
(IMF Country Report No. 10/308, October 2010)

	2007	2008	2009 (Estimation)	2010 (Program)	2011 (Projection)
Output, prices and labor market (change in percent)					
Real GDP growth	6,9	5,5	-3,0	1,5	3,0
Real GDP growth excluding agricultural sector	8,8	5,2	-3,4	2,0	3,1
Real domestic demand (absorption)	11,5	6,3	-6,7	-0,9	1,3
Consumer prices (average)	6,5	12,4	8,1	5,1	5,4
Consumer prices (end of period)	11,0	8,6	6,6	6,8	5,0
Nominal gross wage	22,4	16,9	7,4	3,8	7,4
Real net wage	19,9	4,9	-0,7	-1,2	1,9
General government finance (in percent of GDP)					
Revenue	43,5	41,9	39,5	38,8	38,0
Expenditure	45,4	44,5	43,6	43,6	42,0
Fiscal balance	-1,9	-2,6	-4,1	-4,8	-4,0
Public debt	35,2	33,4	35,6	40,5	41,6
Monetary sector (end of period 12-month change, in percent)					
Money (M1)	25,3	-3,8	8,7	1,9	18,3
M3[1)]	44,5	9,6	21,8	11,1	16,9
Domestic credit to non-government	36,9	35,0	8,9	16,1	15,5
Balance of payments (in percent of GDP)					
Current account balance	-15,9	-17,6	-6,7	-9,0	-8,8
Export of goods	22,2	22,2	19,4	22,2	23,7
Import of goods	45,2	45,0	35,9	38,4	38,6
Trade of goods balance	-23,1	-22,8	-16,6	-16,2	-14,9
Capital and financial account balance	18,4	12,7	11,7	4,8	8,6
External debt	61,8	65,2	74,2	78,8	76,2
of which: Private external debt	39,5	46,1	50,4	51,4	49,4
Gross official reserves (in billions of euro)	9,5	8,2	10,6	10,0	10,0
REER (annual average change, in percent; + indicates appreciation)	7,2	6,4	-7,1	-4,0	3,0

[1)] Excluding frozen foreign currency deposits.

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

Executive Board Meetings and Changes in the Key Policy Rate in 2010

The Law on Amendments and Supplements to the Law on the National Bank of Serbia (“RS Official Gazette”, No 44/2010) establishes the Executive Board as the National Bank of Serbia’s body that takes over all responsibilities of the Monetary Policy Committee.

Date	Key policy rate (p.a., in %)	Change (in basis points)
Meetings held		
12 January	9.5	0
21 January	9.5	0
4 February	9.5	0
22 February	9.5	0
5 March	9.5	0
23 March	9.0	-50
8 April	8.5	-50
20 April	8.5	0
11 May	8.0	-50
19 May	8.0	0
7 June	8.0	0
22 June	8.0	0
2 July	8.0	0
22 July	8.0	0
5 August	8.5	50
19 August	8.5	0
7 September	9.0	50
14 October	9.5	50
Planned meetings in 2010		
11 November		
9 December		
Planned meetings in 2011		
13 January		
10 February		
10 March		
7 April		
12 May		
9 June		
7 July		
11 August		
8 September		
6 October		
10 November		
8 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 5 August 2010

At today's meeting, the NBS Executive Board discussed current economic developments and decided to raise the key policy rate by 0.5 percentage points to 8.5%.

By tightening monetary policy, the Board had in mind that some of the risks referred to in the May Inflation Report have in the meantime materialised. These risks are associated with the influence of weaker agricultural performance on growth in food prices in domestic and foreign markets, as well as with the impact of higher risk premium on import prices. We estimate that y-o-y inflation will reach around 5% in July, which is higher than anticipated at the time of the May Report.

A decline in agricultural product prices in June and July was much smaller than seasonally expected. In addition, a hike in primary agricultural product prices (mainly wheat and corn) is likely to exert pressure on a number of processed food products.

The rise in risk premium sparked by the public debt crisis in some eurozone members has led to further weakening of the dinar despite favourable macroeconomic indicators regarding expected and actual economic growth and balance of payments deficit. The weaker dinar has fed through into higher import prices whose impact on inflation has so far been contained by the low aggregate demand.

Aggregate demand continues to produce disinflationary pressures. However, the pace of economic recovery suggests that these pressures will probably weaken, especially in light of the lifting of the freeze on public sector wages and pensions announced for April 2011.

In view of the above, the Executive Board of the NBS judges that the increase in the key policy rate by half a percentage point is needed for the achievement of medium-term inflation targets (4.5±1.5% for end-2011 and 4±1.5% for end-2012).

The next meeting of the NBS Executive Board will be held on 19 August 2010.

Press release from Executive Board meeting held on 19 August 2010

After reviewing current economic developments in its meeting today, the NBS Executive Board decided to keep the key policy rate unchanged at 8.5 percent.

The next meeting of the Executive Board is scheduled to take place on 7 September.

Press release from Executive Board meeting held on 7 September 2010

After reviewing current economic developments at its meeting today, the NBS Executive Board decided to raise the key policy rate by 0.5 percentage points to 9 percent.

The Executive Board has decided to tighten its monetary policy stance due to materialization of some of the risks relating to the impact of a relatively poor agricultural season on growth in food prices in the domestic and international markets, as well as expectations of a somewhat faster recovery in aggregate demand. It has been estimated that year-on-year CPI inflation in August 2010 will move around the midpoint of the target set for that month (6.7±2%), which is higher than anticipated at the time of the August Inflation Report.

Poor agricultural season and rising international agricultural product prices fed trough into considerably higher prices of domestic food, which proved to be the key driver of inflation growth over the past several months. There was barely any seasonal decline in agricultural product prices in August, while prices of processed food edged up.

Continued economic recovery, mild lending activity growth, and earlier than planned unfreezing of public sector wages and pensions are dampening the disinflationary impact of aggregate demand that has so far been pronounced.

In view of the above, the NBS Executive Board judges that the 0.5 percentage point increase in the key policy rate is needed in order to contain medium-term inflation within the set targets (4.5±1.5% for end-2011 and 4±1.5% for end-2012).

The next rate-setting meeting of the NBS Executive Board is scheduled for 14 October 2010.

Press release from Executive Board meeting held on 14 October 2010

After reviewing current economic developments at its meeting today, the NBS Executive Board decided to raise the key policy rate by 50 basis points to 9.5 percent.

The Executive Board took into account pressures generated by inflation expectations fuelled by the growth in food prices, and to a lesser degree, pressures generated by the past depreciation and expected faster recovery in aggregate demand. It is currently estimated that year-on-year CPI inflation in October 2010 will move above the upper bound of the target tolerance band set for that month (6.3±2%), which is higher than anticipated at the time of the August Inflation Report.

By raising the key policy rate, the National Bank of Serbia seeks to ensure the achievement of medium-term inflation target.

The temporary rise in food prices resulting from poor agricultural season in Serbia and worldwide has been the key driver of inflation growth over the last several months.

Notwithstanding stabilisation of the foreign exchange market, past depreciation of the dinar will continue to feed through into higher import prices for some time yet.

Continued economic recovery, as well as the decision to lift the freeze on public sector wages and pensions, is likely to dampen the disinflationary impact of aggregate demand.

In view of the above, the NBS Executive Board judges that the 50 basis points increase in the key policy rate is needed in order to contain medium-term inflation within the set targets (4.5±1.5% for end-2011 and 4±1.5% for end-2012).

The next rate-setting meeting of the NBS Executive Board is scheduled for 11 November 2010.

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