



National Bank of Serbia

2011
November

INFLATION REPORT

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NATIONAL BANK OF SERBIA

Belgrade, Kralja Petra 12,

Tel.: +381 11 3027-100

Belgrade, Nemanjina 17,

Tel.: +381 11 333-8000

www.nbs.rs

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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 decisions¹ and underpin activities of the National Bank of Serbia.

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

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

The November *Inflation Report* was adopted by the NBS Executive Board in its meeting of 11 November 2011.

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*

Diana Dragutinović, *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
EFSF – European Financial Stability Facility
EIB – European Investment Bank
EMBI – Emerging Markets Bond Index
EMU – Economic and Monetary Union of the EU
FDI – foreign direct investment
Fed – Federal Reserve System
FISIM – Financial Intermediation Services Indirectly Measured
GDP – Gross Domestic Product
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
mln – million
NAVA – non-agricultural value added
NPLs – non-performing loans
OPEC – Organisation of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
q-o-q – quarter-on-quarter
s-a – seasonally-adjusted
SDR – Special Drawing Rights
WTO – World Trade Organisation
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

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I Overview

Inflation continued to fall, returning to single digits in September.

Year-on-year inflation continued down in the third quarter of 2011, moving along the central projection path from the August Report. It returned to single digits in September, measuring 9.3% (monthly target: 4.9%±1.6 pp). Inflation declined in response to the waning cost-push pressure on food prices and low aggregate demand, as well as in response to past monetary policy measures.

The third quarter saw deflation and...

Consumer prices fell by 0.4% in the third quarter, thanks to the drop in fruit and vegetable prices. The prices of processed food slowed down further, reflecting lower input costs in their production. Conversely, the prices of non-food products recorded temporary acceleration on the back of several larger price increases. Administered price growth was much slower than in the first half of the year.

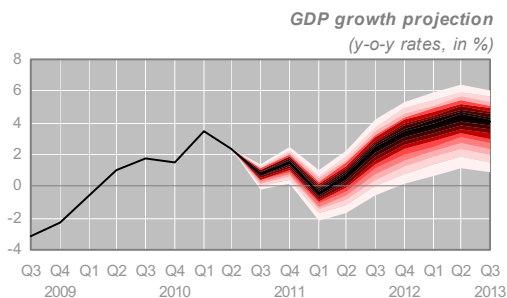
... a fall in economic activity.

Economic activity is estimated to have declined in the third quarter (0.4% s-a drop in GDP), due to a decline in both industrial production and retail and wholesale turnover. On the other hand, most services sectors, as well as agricultural production, recorded an increase.

The slowing of most world economies ...

Unfavourable economic growth indicators for the second and third quarters, as well as mounting doubts about public debt sustainability of some euro area members, have led to a downward revision of growth projections for 2011 and 2012 for most countries. Because of high public debt levels, the governments can no longer respond by fiscal stimuli as they did during the first wave of the crisis, which gives rise to fiscal and financial uncertainty worldwide.

... has led to a revision of Serbia's GDP growth projections for 2011 and 2012.



As the growth forecasts of Serbia's key trading partners have been cut, our projection of GDP growth was revised to around 2.0% in 2011 and 1.5% in 2012. Economic activity will expand moderately this year, primarily on the back of private sector investment. The contribution of net exports will be positive, but modest due to lower economic growth worldwide.

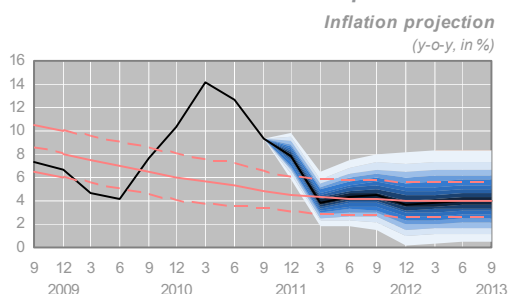
Notwithstanding the rise in country risk premium in the third quarter, ...

... the exchange rate remained relatively stable.

Inflation expectations started declining...

... and the monetary easing continued.

Inflation is expected to retreat within the target band in the first quarter of 2012.



The key policy rate is more likely to be lowered further than raised or kept on hold.

Heightened uncertainty in the global financial market fed through into higher risk premiums throughout the region.

Notwithstanding the rise in country risk premium, the exchange rate of the dinar stabilised from end-July onwards, with practically no interventions by the National Bank of Serbia. The stability of the exchange rate was underpinned by FDI inflows and the conclusion of a new arrangement with the International Monetary Fund.

After standing still for six months, inflation expectations started declining in October. This trend is expected to continue in the coming period, providing an additional impetus to the process of disinflation.

Past monetary policy measures moderated the rise in inflation expectations, thereby preventing the spill-over of the inflation shock from food to other prices. This paved the way for gradual monetary easing beginning from June. The key policy rate was cut from 12.0% in June to 10.0% in November in order to bring medium-term inflation back to the target, without causing major volatility.

According to the November projection, and consistent with those released in August and May, inflation is expected to return within the target band in the first quarter of 2012 and move within the bounds of the target in the period thereafter. The key disinflationary factor in the medium run will be low aggregate demand. The drop in inflation expectations will also play a role.

The key risks to inflation projection are associated with movements in the international environment and potential fiscal expansion at home.

Based on the current inflation projection and its underlying risks, the Executive Board of the National Bank of Serbia judges that the key policy rate is more likely to be lowered in the coming period rather than raised or kept on hold.

II Monetary policy since the August Report

Further key policy rate cuts marked continuation of the monetary easing cycle that started in June.

The NBS continued the monetary easing cycle, in train since June, with a view to steering medium-term inflation back within the target band, without causing major volatility. The key policy rate was lowered in July and September by 25 and 50 bp, respectively. Downward revisions followed in October, by 50 bp, and in November by 75 bp to the level of 10.0%. Gradual relaxation of monetary policy has been enabled by the past monetary policy measures which precluded the rise in inflation expectations and, by extension, the pass-through from food to other prices.

The Executive Board decided to lower the key policy rate in July based on assessment that inflationary pressures stemming from food prices had continued to weaken and the possibility that food prices could provide a negative contribution to inflation once the new agricultural season set in. Besides, it was estimated that the full spill-over effect of lower global wheat and corn prices was yet to be felt in the Serbian market, which would further lessen the cost-push on food prices domestically. The Executive Board also took into account the persistently strong disinflationary impact of aggregate demand and the gradual waning of inflation expectations.

The August rate-setting meeting was overshadowed by the deepening public debt crisis in the euro area periphery and heightened uncertainty about its future impact. The Executive Board considered the August inflation projection which, similar to the one released in May, placed inflation's return within the target band in H1 2012. It was concluded that the key drivers of the disinflation process would be the drop in prices, resulting from good agricultural performance, and low aggregate

demand. The fall in y-o-y inflation rates should lead to a drop in inflation expectations, providing in turn an additional impetus to the disinflation process. This notwithstanding, the Executive Board decided to keep the key policy rate on hold considering possible wider implications of risks in advanced economies, as well as fiscal risks at home.

By the next rate-setting meeting in early September, it became clear that most world economies were faltering and that the downward revision of their growth projections for 2011 and 2012 was inevitable. Serbia's GDP growth forecasts for 2011 and 2012 were also scaled back in response to the slowing global recovery, especially of the euro area². The Executive Board voted to cut the key policy rate, judging that low aggregate demand would continue to be a strong disinflationary factor, that food prices would stabilise and the growth in regulated prices slow down. Further deepening of global economic problems remaining a possibility, the Executive Board announced almost certain conclusion of a precautionary stand-by arrangement with the IMF in order to alleviate possible implications of the risks stemming from some advanced economies. Compliance with fiscal responsibility rules was underlined as critical to safeguarding macroeconomic stability and reducing the country risk.

Inflation declined in Q3, moving along the central projection path from the August Report. At end-September, it measured 9.3% compared to the monthly target of 4.9±1.6%. Despite falling, y-o-y inflation stayed above the upper bound of the target tolerance band in the last six months (April–September). The National Bank of Serbia therefore sent an open letter to the Government in October to explain the reasons for the divergence, the actions taken and the time needed to bring inflation back within the target.³

² See Text box 2, p. 33.

³ See Appendix, p. 43.

In accordance with the inflation projection and the unchanged balance of medium-term risks, the Executive Board decided in its October and November meetings to proceed with monetary easing. This decision was based on assessment that, in addition to low aggregate demand, the disinflation process would be aided by the nascent decline in inflation expectations. The precautionary

stand-by arrangement, aiming to support the Republic of Serbia's economic policy and concluded with the IMF in-between two rate-setting meetings, was highlighted as a factor that would help improve the investment climate and provide an additional buffer to the domestic economy against adverse external effects of the crisis.

III Inflation developments

Y-o-y inflation continued towards the target, entering the single digit zone in September. Food prices continue to produce disinflationary pressures, reflecting the waning of effects of the last year's shock.

Y-o-y inflation will proceed towards the target in Q4 2011.

Inflation developments in Q3

Q3 recorded deflation of 0.4%. Prices declined in response to a further drop in food prices, i.e. prices of fruit and vegetables.

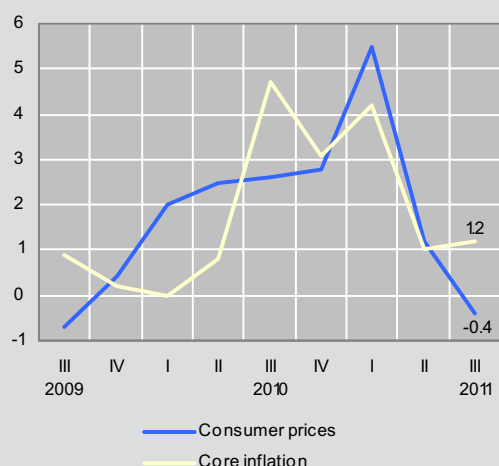
Y-o-y inflation continued down to 9.3% in September (target: 4.9%±1.6 pp), consistent with the central projection in the last *Inflation Report*.

Consumer prices declined by 0.4% owing to a heftier than seasonally expected decline in fruit and vegetable prices. Growth in food prices continued to slow, mirroring the plummeting prices of their inputs.

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

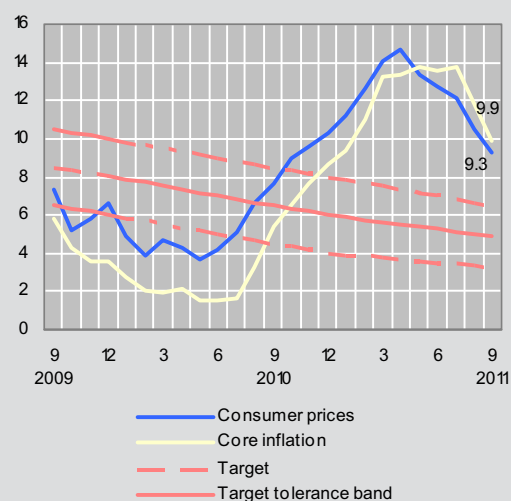
	XII 2010 XII 2009	III 2011 III 2010	VI 2011 VI 2010	IX 2011 IX 2010
Consumer prices	10.3	14.1	12.7	9.3
Core inflation	8.8	13.2	13.6	9.9
Industrial producer prices	16.2	17.1	15.8	12.3
Agricultural producer prices	29.3	39.1	28.6	11.6

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



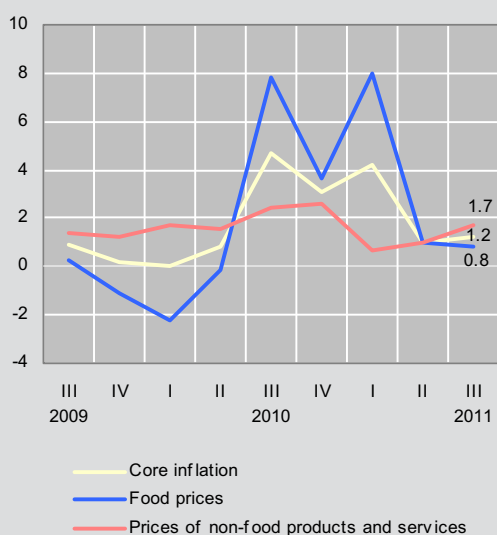
A drop in food prices was sharper than a rise in prices of non-food products and services within core inflation, resulting in Q3 deflation.

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



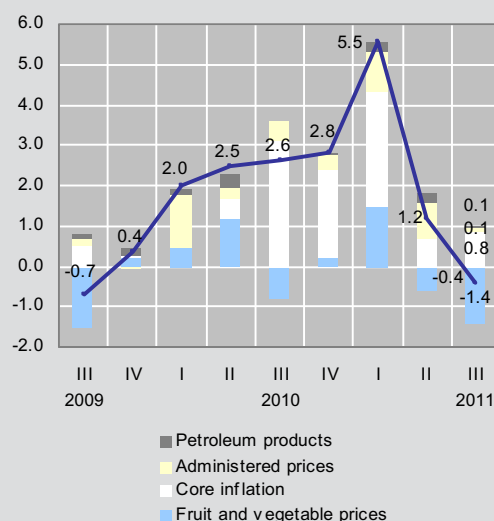
Y-o-y inflation continued down, entering into the single-digit zone in September.

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



Food price growth continued to slow in Q3, while a rise in prices of non-food products and services accelerated.

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



Q3 deflation was due to falling fruit and vegetable prices.

Core inflation (market determined prices) sped up in Q3 (1.2%⁴, contribution of 0.8 pp), on the back of accelerated growth in prices of non-food products and services (1.7%, contribution of 0.6 pp), notably of household chemicals (detergents), textbooks, coal and wood. In contrast, food price growth slackened further (0.8%). For the first time in the year, growth in food prices was lower, by as much as two times, than that in non-food products and services.

Fruit and vegetable prices declined further (23.4%, contribution of -1.4 pp), despite drought conditions during August and September. The decline was due to good yields of most agricultural crops which was also reflected in higher exports and smaller imports of fruit and vegetables in Q3. Thanks to falling prices of fruit and vegetables, as well as of primary agricultural commodities (wheat, corn, etc), cost pressures on food producers weakened further in Q3. Fruit and vegetable prices recorded a drop in September, for the first time on CPI record.

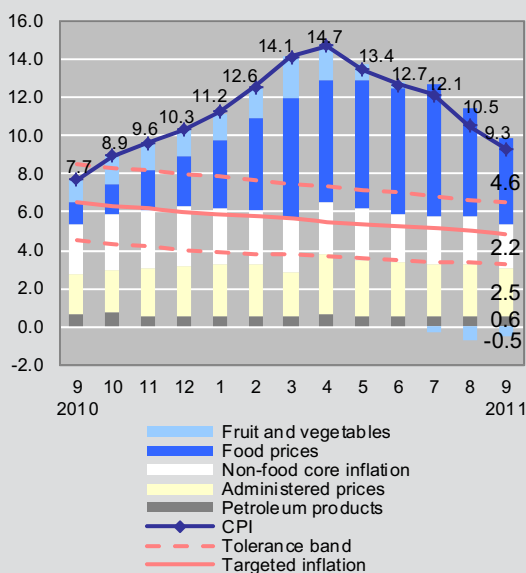
Administered price growth slowed (0.4%, contribution of 0.1 pp). A rise in this group of prices is mainly due to

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

	2010		2011		
	Q3	Q4	Q1	Q2	Q3
Consumer prices	2.6	2.8	5.5	1.2	-0.4
Core inflation	4.7	3.1	4.2	1.0	1.2
Fruit and vegetables	-11.7	3.7	25.3	-9.1	-23.4
Administered prices	2.2	1.8	4.7	4.1	0.4
Electricity	0.0	0.0	0.0	13.5	0.0
Gas for households	0.0	0.0	0.0	0.0	0.0
Utility-housing services	5.9	9.9	3.3	1.8	0.1
Social welfare services	0.0	2.5	0.0	0.3	0.6
Transport services (regulated)	1.7	0.1	13.1	0.5	0.5
Postal and telecommunications services	0.0	0.0	0.0	0.0	9.2
Cigarettes	5.6	0.0	19.1	-2.6	-1.3
Medications	1.8	3.0	3.8	2.5	-2.2
Other	0.8	0.2	0.2	0.0	0.1
Petroleum products	0.8	1.3	5.1	5.6	2.0

⁴ Q2 core inflation was 1.0%.

Chart III.0.5 Contribution to y-o-y consumer price growth
(in percentage points)



Y-o-y inflation declined in Q3 chiefly in response to falling prices of food products and fruit and vegetables.

the August increase in prices of landline telephony services (0.2 pp), whilst a drop was noted for prices of cigarettes and medicaments. In the year to September, administered prices hiked 9.5% (against 7±2% growth agreed with the Government for 2011).

Petroleum product prices rose in Q3, though less than in the two prior quarters (2.0%, contribution of 0.1 pp). Despite the fall in Ural oil prices in Q3⁵, petroleum product prices rose due to a contraction in supply as overhauls were undertaken in some domestic plants.

On the expenditure side, growth in **industrial producer prices** in the domestic market slowed to 0.2%⁶ in Q3, driven mainly by the rise in energy prices. Broken down by industry, the greatest contribution to slower price growth came from a 2.1% decline in food industry prices. A y-o-y increase in industrial producer prices in the domestic market continued to weaken and reached 12.3% at end-Q3.

⁵ Average price in Q3 vs. average price in Q2.

Agricultural producer prices⁷ declined further in Q3 (0.2%), mostly on account of prices in the farming sector (3.3%). A fall was also noted for prices in the sectors of fruit and wine growing. Y-o-y growth in agricultural producer prices slowed to 11.6% in September.

Inflation expectations

Economic agents have begun to revise downward their inflation expectations.

Anchored over six months, inflation expectations were revised downward in October and pared back further in November. This tendency is likely to persist as inflation rates continue to decline. A drop in inflation expectations will, in turn, provide an additional boost to the disinflation process.

According to the Bloomberg survey, one-year ahead inflation expectations of the financial sector stayed unchanged at 8.0% in Q3. In October, financial sector analysts responded to a decline in inflation and revised their expectations down by 1 pp – to 7.0%. Expectations edged down further to 6.7% in November.

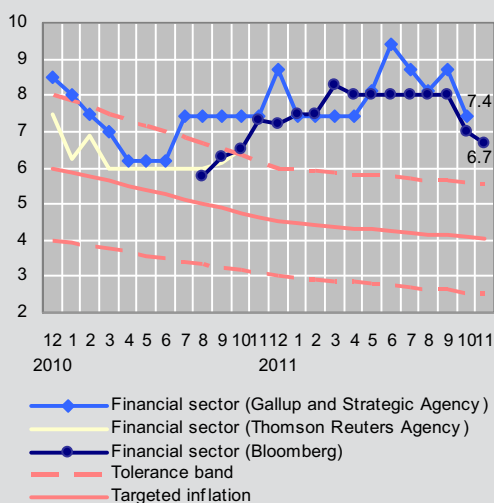
The Gallup survey also signals a downward trend in inflation expectations. Relative to end-Q2, they declined in all sectors. Financial sector and household expectations dropped in July and August (from 9.4% and 15.4% in June to 8.1% and 12.7% in August, respectively), only to pick up to (July) levels of 8.7% and 14.0% in September. The sector of agriculture expected lower one-year ahead inflation in August (10.0%), while its expectations in the remaining two months of Q3 hovered at 11.4%. Trade union expectations drifted down to 10.0% in September, following the period of stability over the prior three months (11.4%). A continuing decline in inflation expectations is confirmed by the October survey as all sectors but trade unions reported a downturn.

One-year ahead inflation expectations remain above the inflation target, though the difference between the expected and targeted inflation has begun to shrink. We expect a further decline in inflation expectations. Once inflation returns within the target band in Q1 next year, expectations will retreat within the target band as well.

⁶ Industrial producer prices in the domestic market rose by 2.1% in Q2.

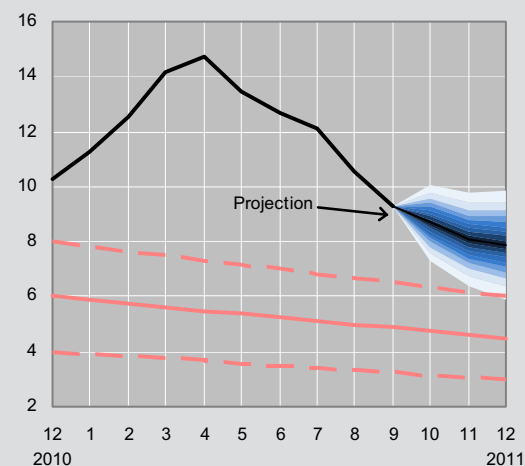
⁷ Producer prices in the sectors of agriculture and fishing.

Chart III.0.6 One-year ahead expected and targeted inflation
(in %)



A decline in inflation expectations, set in train in October, continued in November.

Chart III.0.7 Short-term inflation projection
(y-o-y growth, in %)



According to the short-term projection, inflation will continue towards the target in Q4.

Inflation outlook for Q4

Y-o-y inflation will proceed towards the target in Q4.

Core inflation is expected to provide the strongest impetus to a decrease in y-o-y inflation. Besides, inflation will proceed towards the target under the effect of high last year's base (higher monthly inflation rates in Q4 2010). In q-o-q terms, following deflation in Q3, consumer prices are expected to rise in Q4, driven mainly by a seasonal hike in fruit and vegetable prices.

Growth in Q4 core inflation is likely to slacken both in regard to its food and non-food component. The contribution of food to CPI growth will probably be small owing to the realised, but statistically still non-recorded price decreases (wheat flour, bread), announced price cuts (vegetable oil, sugar, etc) and a further drop in world food prices. Following acceleration in Q3, growth in prices of non-food products and services is likely to be weaker in Q4. Dampened aggregate demand remains the principal disinflationary factor.

According to our estimates, a rise in fruit and vegetable prices will be higher than typical for a fourth quarter, on account of a steeper than usual seasonal drop in Q3.

Administered price growth is likely to be somewhat higher than in Q3, though still relatively low. Administered prices will rise most in response to the announced increase in natural gas and housing-utility (heating) prices. Higher public transport fares will have an insignificant impact on consumer price growth in Q4 owing to their small weight in the CPI basket of goods and services.

As estimated, petroleum product prices will probably have a negligible effect on quarterly inflation in Q4.

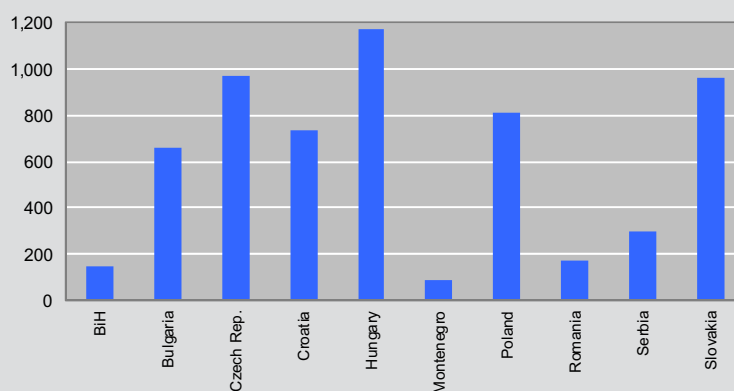
The key risk to the short-term inflation projection is associated with the uncertainty surrounding food price movements.

Text box 1: Advancing Serbia's agricultural production and easing instability of food prices

The World Bank expert analysis¹ recognized agriculture as a strategic economic activity of Serbia. However, frequent changes of agrarian policy and focussing on short-term issues create an unpredictable business environment deterring long-term investments into agriculture. Such policy has also added to the high instability of food prices in the country. Therefore, there is still ample room for improvement of agricultural production in Serbia through higher yields, lowering of costs and larger investments into higher value added products.

Rather than from high and competitive exports, Serbia's net food exports surplus since 2005 has stemmed from low imports (due to low purchasing power and high domestic supply). This is further confirmed by the fact that Serbia's exports per hectare of arable land is still one of the lowest in Europe (Chart O 1.1). One of the causes, according to the World Bank experts, lies in the current customs protection system, which hinders effective use of resources – high customs duties on particular products stimulate import-substitution at the expense of exports in areas where Serbia has comparative advantage. The World Bank therefore proposes further agricultural market liberalisation, a process that will be aided by the EU integration and WTO accession.

Chart O 1.1 Value of exports per hectare of arable land in 2010
(in EUR)



Sources: UN Comtrade, European Commission, Eurostat.

The World Bank experts also find that a change in addressing problems in market operation would be desirable. The market should be left to the private sector, while the state needs to modify the character of agrarian policy interventions, so as to focus more on fundamental problems instead of taking short-term measures to deal with burning issues. Statistics in this domain should therefore also be improved, in order to ensure quality information for the analysis of the effects of specific measures, leading ultimately to their increased effectiveness.

The agrarian budget, the key instrument of agrarian policy, should be increased and restructured, with a view to cost-effective use of existing resources in agriculture. The current system of subsidies per unit of arable land, favouring large producers and crop farming, should be redesigned toward more equitable development. It is also suggested that a part of the budget should be used for subsidies aimed at enhancement of product quality and introduction of latest food health standards in order to access the developed EU markets and boost exports.

¹ According to: Economic Memorandum for Serbia (under preparation), World Bank.

The Serbia's commodity reserves system should be reviewed from the standpoint of food market regulation, given that, instead of easing, its occasional and unpredictable interventions only fuel the volatility of food prices.

A network of expert advisory services recently set up by the state will also help to change the mindset and behaviour of agricultural producers toward higher productivity and quality. In its future actions, the state might endeavour to create conditions for more effective functioning of the production chain (investments into warehouses, cold-storage, processing and transport of agricultural products). Creation of a level playing field conducive to stronger competition in the production and trade chain of food production and distribution could lead to easing of food prices volatility.

IV Inflation determinants

1 Money and capital market trends and bank lending

Interest rates

Further monetary policy easing induced a contraction in money market interest rates and interest rates on dinar loans. Due to heightened uncertainty in global financial markets and dented demand, effective rates on government securities failed to decline.

Money market rates continued to contract in response to further easing of monetary policy. BEONIA, the rate in the interbank overnight money market, continued to trend below the key policy rate level in Q3. Relative to Q2, the average decline in BEONIA was similar to that in the key policy rate – the average deviation came at -0.9 pp. The

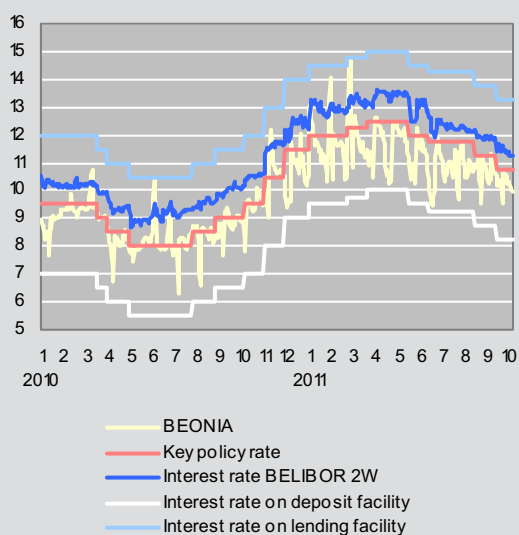
fact that BEONIA contracted in the setting of elevated bank lending in repo securities confirms increased banking sector liquidity.

BELIBOR rates mirrored the movements in the key policy rate. In terms of the average in the last month of the quarter, a heftier fall was recorded for longer-maturity rates. By end-Q3, BELIBOR ranged from 11.8% for the shortest to 12.7% for six-month maturity.

Interbank money market rates declined further in October. BEONIA lost 0.3 pp on average, while BELIBOR rates shrank by between 0.3 and 0.5 pp.

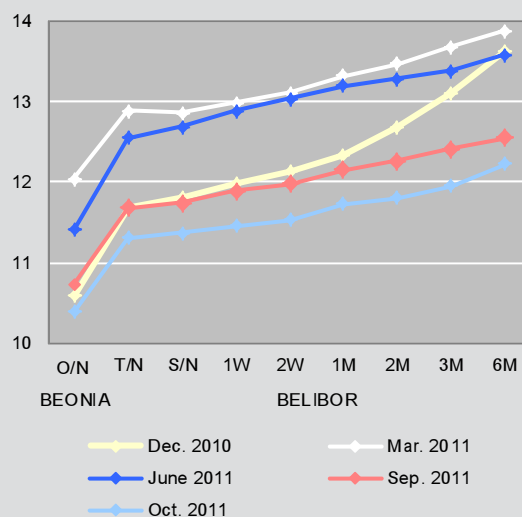
Despite monetary policy relaxation, effective rates in the primary market of government securities failed to decline in Q3 primarily due to increased uncertainty in global financial markets, which lessened the interest of both foreign and domestic investors in government securities.

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



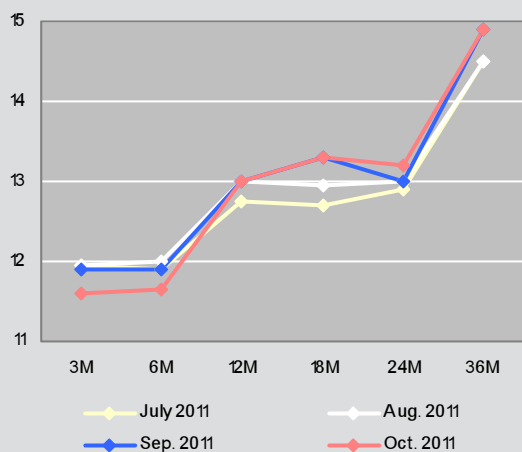
Money market interest rates mirrored the movements in the key policy rate.

Chart IV.1.2 Yield curve in the interbank money market (average monthly value, %, p.a.)



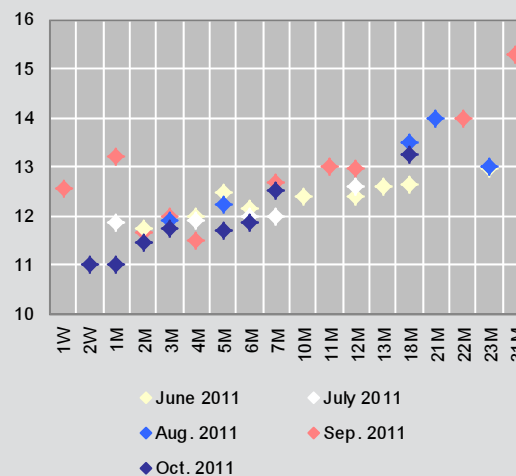
Monetary policy easing determined the interest rate movements in the interbank money market.

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



In an environment of elevated risk, investors were more willing to invest in short-term securities.

Chart IV.1.4 Yield curve in the secondary market of government securities
(weighted average monthly values, %, p.a.)



The sharp yield rise in September was discontinued in October.

In circumstances of rising risk premium, foreign investors tend to avoid any additional risk – in this case, currency risk.

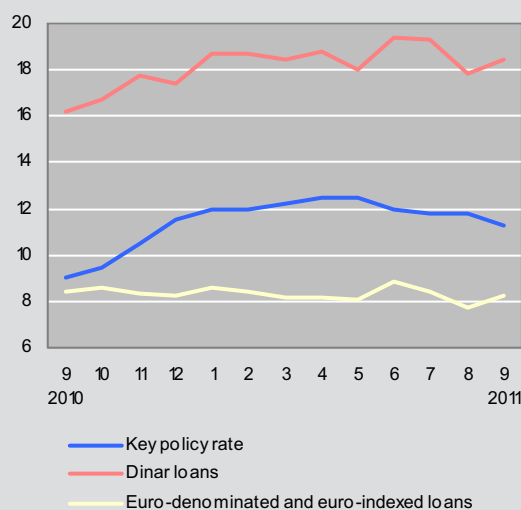
The reduced issue of shorter-maturity government securities (down to RSD 28.0 bln) reflected receding demand, leaving 3- and 6-month effective rates broadly unchanged. Depressed demand for longer-maturity government securities prompted a rise in effective rates – from 0.5 pp for 1-year and 1.0 pp for 3-year maturity.

October heralded more positive trends – rates on short-term government bills contracted (by 25 and 30 bp), while a rise in longer-maturity effective rates was discontinued. Flat throughout Q3, the 2-year rate was the only rate that rose – by 0.2 pp in October.

An auction of 18-month, euro-denominated government securities was held in July (EUR 150 mln nominally), with almost maximum performance (99.8%) – the auction closed at 5.4%.

Relative to Q2, trading volumes in the secondary market of government securities⁸ fell by 38.0%. Low trading volumes were particularly pronounced in July and August. By end-Q3, shorter-maturity rates of return

Chart IV.1.5 Interest rates on new corporate and household loans*
(p.a, %)



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

The price of dinar, FX and FX-indexed loans declined relative to Q2.

⁸ Excluding trading until the primary market settlement date, which is not considered true secondary trading.

mirrored the trends in the primary market, while returns on longer-maturity securities exceeded those in the primary market.

A rise in the slope of the yield curve in the primary and secondary markets of government securities was shaped by external factors. A reduction in the curve slope and level may be expected only with the stabilisation of trends in the global financial market.

Rates on newly extended dinar loans mirrored the trends in the key policy rate in Q3. A sharper fall in interest rates was recorded for household loans.

In conditions of relatively stable EURIBOR rates, rates on euro-denominated and euro-indexed loans declined as well, though to a lesser degree, in both corporate and household sectors. A lesser decline in household rates was due to increased rates on housing and consumer loans, prompted by greater disbursement of commercial housing loans and no further extension of subsidised consumer loans.

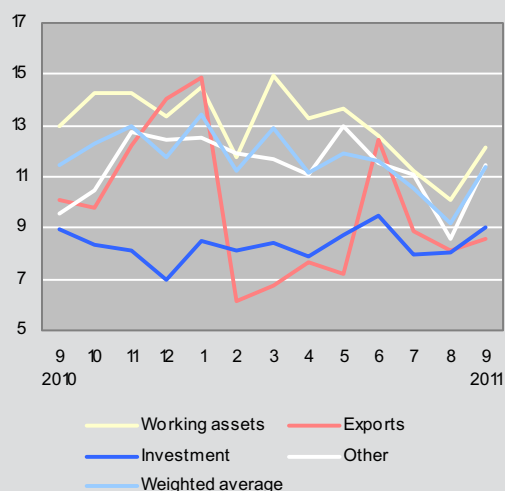
At the quarterly level, all corporate loan rates declined. A reduction was noted for the most common corporate loans – current assets and investment loans, while export loans (with a smaller share in the total) recorded the steepest fall.

Weighted average rates on new deposits declined as well. In September, rates on household term deposits of up to one-year maturity came at 9.9% for dinars and 3.7% for euros, down by 0.9 and 0.6 pp on June. In the corporate sector, the rate on term dinar deposits with up to one-year maturity fell by 1.4 pp in Q3 (to 10.9%), while the rate on same maturity euro deposits stayed flat (3.8%).

Stock exchange trends

Heightened uncertainty in the global financial market bore down on all regional stock exchanges, not sparing the Belgrade stock exchange either.

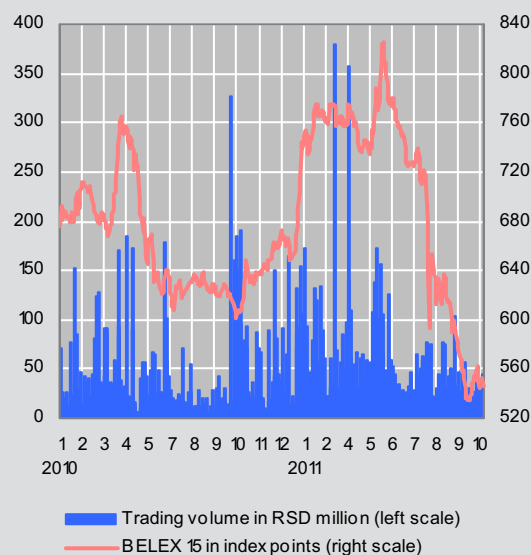
Chart IV.1.6 Interest rates on dinar corporate loans*
(p.a, %)



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

Interest rates on all types of corporate loans declined.

Chart IV.1.7 Belex 15

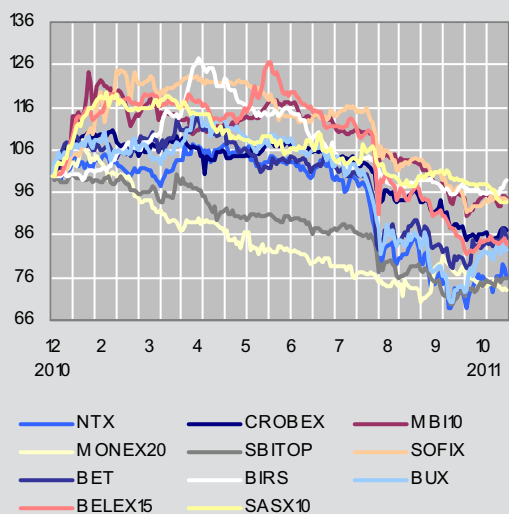


Source: BSE.

Adverse developments that unfolded by end-Q2 continued into Q3.

Chart IV.1.8 Stock exchange indices across the region

(in index points, normalised, 31. 12. 2010 = 100)



All regional stock exchange indices tumbled in Q3.

As the global turmoil spilled over to Serbia instantly, a fall in prices of shares listed on the Belgrade Stock Exchange (BSE), set in train in June, intensified in the months that followed. BSE indices lost more than a fifth of their value in Q3. BELEX15, the index of the most liquid shares, plummeted 26.1%, while the general, BELEXline index recorded a softer fall of 22.0%. Though rising over the first five months, BSE indices declined by c. 15% from early 2011.

BSE trading volumes contracted as well. Total stock trading amounted to RSD 4.4 bln, down by 42.2% on Q2. Foreign investor participation totalled 51.4%. Low net non-resident share purchases can be explained by increased investor aversion to risk in an environment of adverse global developments. This also affected the behaviour of domestic investors.

Albeit higher than in Q2, trading in frozen FX savings bonds remained low in Q3 (RSD 0.6 bln) with 2014-series bonds being traded the most. As at 30 September, the yield to maturity for frozen FX savings bonds moved from 6.1% for A2012-series to 4.9% for A2016-series bonds.

As share prices tumbled, overall market capitalisation of the BSE contracted by RSD 45.6 bln in Q3, reaching RSD 853.5 bln at end-September.

Heightened global uncertainty impacted on stock exchanges in the rest of the region as well and dragged down on their indices in Q3. Montenegro and Sarajevo indices fell the least (MONEX20: -2.2% and SASX: -9.9%), whereas the Budapest stock exchange was hit most severely – its index plunged by 30.5%.

Following adoption of eurozone stabilisation measures in late October, the devaluation of shares was halted both on the BSE and stock exchanges in the region. At end-October, BELEX15 was broadly flat relative to end-September (-1.2%), while most regional stock exchanges recorded a moderate pick-up.

Monetary aggregates

Money supply continued up in Q3. As inflation receded, a real y-o-y decline in monetary aggregates slowed further.

Total reserve money increased on end-Q2 (3.3% in nominal and 4.1% in real terms), with dinar reserve money remaining broadly unchanged (it lost 0.1% nominally and gained 0.3% in real terms).

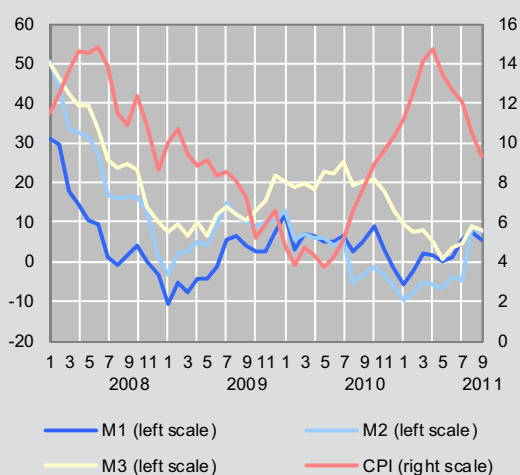
Dinar reserve money was created through FX transactions and a decline in government dinar deposits, and was withdrawn in open market operations. By end-Q3, the repo stock stood at RSD 101.0 bln, up by RSD 27.1 bln on end-Q2.

The composition of dinar reserve money shows an increase in its cash component by RSD 9.9 bln. Bank reserves went down by RSD 10.4 bln mainly due to plummeting free reserves. The volume of required reserves rose by RSD 3.9 bln.

Money supply rose further in Q3. Dinar monetary aggregates M1 and M2 rose 8.7% and 8.4% in real terms respectively, while real growth in M3 came at 6.0%. As a result, a y-o-y fall in money supply slowed further – M1 and M2 shed 3.4% and 1.5% in real terms, whilst M3 gained 11.8%.

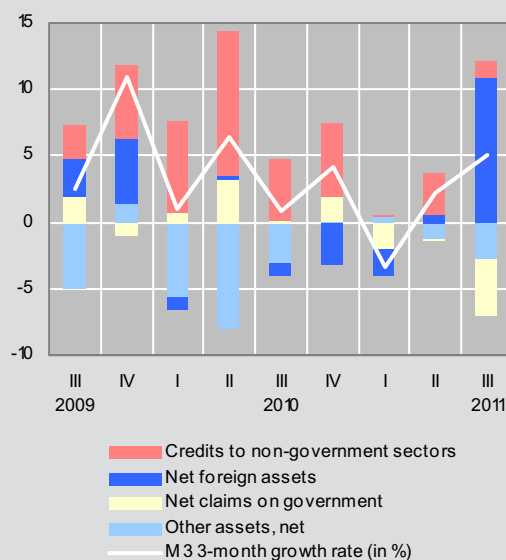
The increase in the dinar component of money supply in Q3 can be attributed to rising balances in current and savings accounts rather than to the increase in cash in circulation. The sharpest rise was noted for short-term deposits – the increase in savings deposits exceeded that in transaction deposits. This rise was mostly due to elevated balances in public enterprise accounts (relating

Chart IV.1.9 Monetary aggregates and CPI
(y-o-y rates, in %)



With inflation on the downward path, a real y-o-y decline in money supply is likely to slow further in the coming period.

Chart IV.1.10 Contribution to M3 growth
(in p.p.)



Rising NFA gave the strongest boost to M3 growth.

to disbursement of the “Srbijagas” loan). Balances in corporate and VPF accounts rose as well. A rise in transaction, rather than savings deposits, accounted for the major part of growth in dinar household deposits. Households continue to favour saving in foreign currency though the NBS’s October survey shows that it was more profitable to save in dinars than in FX over the past 12 months.⁹

Receipts from sale of the “Delta Maxi Group” enterprise were the main driver behind rising FX deposits in Q3. They were used to settle debts of the enterprise, which boosted balances in short-term corporate accounts. Rising FX household savings, lower than in Q2, lifted up M3.

The tendency of a moderate increase in monetary multiplication continued into Q3, on the back of elevated money supply.

Higher growth in money supply than in economic activity induced further deceleration of the velocity of circulation in Q3.

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

	2010		2011		Share in M3 Sep 2011 (%)
	Dec.	March	June	Sep.	
M3	5.9	5.4	5.2	11.8	100.0
FX deposits	12.2	10.3	9.2	13.5	69.3
M2	-14.8	-17.0	-14.7	-1.5	30.7
Time and savings dinar deposits	-20.1	-25.2	-20.4	1.4	12.6
M1	-11.1	-10.4	-10.2	-3.4	18.2
Demand deposits	-10.1	-6.3	-7.5	-3.1	11.5
Currency in circulation	-12.9	-17.0	-14.7	-4.0	6.7

A rise in NFA of banks, i.e. increased external claims and shrinking liabilities had a positive impact on M3 growth. Lending to public enterprises and households resulted in

⁹ Analysis of Profitability of Dinar and FX Savings, October 2011; http://www.nbs.rs/internet/english/90/analize/Analysis_dinar_and_FX_savings_2011.pdf

a 1.1 pp contribution of bank lending to M3 growth. An impetus also came from government borrowing in the domestic market. On the other hand, the effect of the RS eurobonds issue in the international market is for the time being neutral as funds earned are deposited in NBS FX accounts (thus offsetting the effects of higher NFA and lower NDA on this account).

In October, dinar reserve money expanded by RSD 2.3 bln, chiefly in response to lower dinar government deposits. Balances in dinar and FX accounts increased in October, while cash in circulation contracted. These movements, together with appreciation of the dinar, drove up M2 and dragged down on M1 and M3.

Bank lending

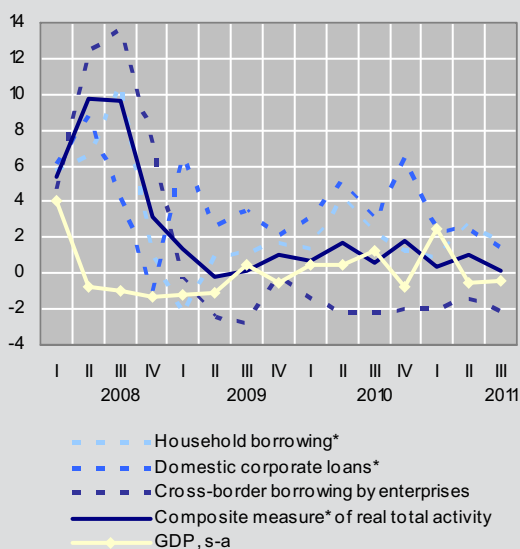
Slower growth in lending activity in Q3 was due to diminished corporate lending. Deceleration was also recorded in y-o-y terms.

By the composite measure¹⁰, corporate and household lending continued to rise, though at a weaker pace than in a quarter earlier. The growth was primarily determined by lending from domestic sources.

Down by 1.0 pp on Q2, a real rise in domestic corporate and household lending amounted to 1.5% in Q3. A slowdown in growth was more pronounced for corporate loans – corporate lending rose by 1.4% and household lending by 1.7% in real terms. Nominally, overall bank lending rose by RSD 15.0 bln. Excluding the effect of exchange rate changes in Q3, it stepped up by RSD 29.8 bln. These trends induced further slowdown in y-o-y lending growth. Real y-o-y growth in lending came at 10.8% in September, down by 1.2 pp from June.

To finance lending, banks continued to tap domestic sources. The majority of funding came from rising deposits (mostly corporate) and banks' recapitalisation. At the same time, banks channelled some of their free funds in safer investment (repo and government

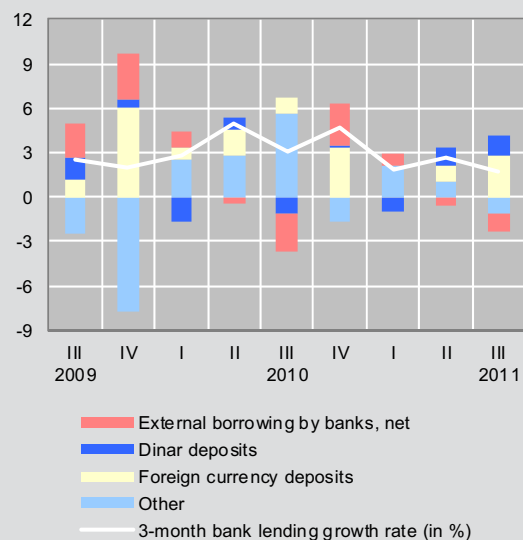
Chart IV.1.11 Loans and GDP
(quarterly growth rates, %)



* Deflated by inflation, excluding the effects of valuation changes.

According to the composite measure, lending continues up, though at a slower pace.

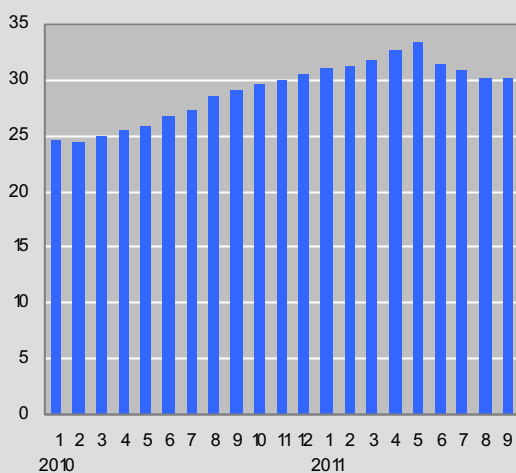
Chart IV.1.12 Contribution to bank lending growth
(in percentage points, excluding the effect of exchange rate changes)



In Q3, banks tapped only domestic sources to finance lending.

¹⁰ As an indicator of overall borrowing, it covers domestic lending (i.e. corporate and household borrowing from domestic banks) and enterprise cross-border borrowing.

Chart IV.1.13 Share of dinar in total bank receivables on corporate and household sectors (%)



Following a decline in June, the share of dinar receivables stabilised at a somewhat lower level in September.

Table IV.1.2 Subsidised loans in 2010 and 2011

	2010		2011		
	Q3	Q4	Q1	Q2	Q3
Government Programme of Measures to Ease the Effects of the Global Financial Crisis					
	(in RSD bln)				
Loans approved	56.3	37.6	27.0	59.0	7.9
Liquidity	34.9	22.7	24.3	50.9	-1.1
Investment	9.0	9.8	1.8	6.6	8.4
Consumer	0.6	1.7	0.9	1.5	0.6
Dinar cash	11.8	3.4	-	-	-
Subsidised housing loans					
	2.5	2.0	0.9	1.3	2.0
Subsidised military loans					
	0.4	0.3	n.a.	0.2	0.5
Subsidised farmers' loans					
	2.6	2.4	n.a.	n.a.	2.7

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

securities). Lending slowed also in response to lower net external borrowing by banks.

Bank claims under corporate loans rose by RSD 6.4 bln, or RSD 14.5 bln excluding the effect of dinar volatility. A decrease was particularly manifest for companies, while lending to public enterprises was at a higher level than in Q2 owing to a loan extended to "Srbijagas". New liquidity loans were predominant – once subsidised liquidity loans were no longer approved, demand was channelled into the commercial segment of the lending market. Given the still satisfactory dynamics of investment lending, investment is likely to provide further boost to economic recovery in the coming period. In contrast, fresh loans for export financing purposes declined in Q3. Most loans were extended to enterprises in the sectors of industry, trade, transport and construction.

During the review period, enterprise liabilities under financial loans contracted by EUR 57.8 mln, while rising by EUR 152.6 mln under trade loans.

In response to reduced disbursement of domestic bank loans and the reduction in outstanding debt on foreign

financial loans, total corporate borrowing stagnated in Q3, but slowed in y-o-y terms.

Household lending picked up by RSD 3.6 bln, or RSD 9.9 bln excluding the effect of exchange rate changes. Housing loans were dominant among the newly extended loans. Relative to Q2, citizens borrowed less for purposes of consumer goods purchases. Borrowing under credit cards stayed broadly the same, while current account overdrafts were somewhat higher than earlier.

RSD 13.1 bln in subsidised loans were disbursed in Q3, of which most in investment loans (RSD 8.4 bln). As funds earmarked for subsidising were depleted in Q3 for the majority of loans, and the budget revision envisages additional funds for housing loan subsidies only, the period ahead is likely to see even lower activity in this segment of the lending market.

The share of dinar loans fell by 1.2 pp to 30.2% in September. While increasing in the household sector, the share of dinar loans is decreasing in the corporate sector. After the extension of subsidised dinar liquidity loans was stopped, fresh dinar lending contracted as well, which affected the growth in FX and FX-indexed loans in the

total. In September, the share of dinar in newly extended loans rose to 41.1%, which may signal the discontinuation of negative trends from June.

The loan repayment capacity measured by the share of NPLs was somewhat weaker than in Q2. In September, total NPLs share came at 18.8% under the gross principle (or 11.6% under the net principle), up by 0.2 pp on June. The share of corporate loans in arrears over 90 days was up 0.7 pp to 24.4%. Household loan arrears rose by 0.3 pp to 8.4% in September. Despite a high share of NPLs, other relevant indicators signal banking sector stability – the loan loss provision equals 128.2%.

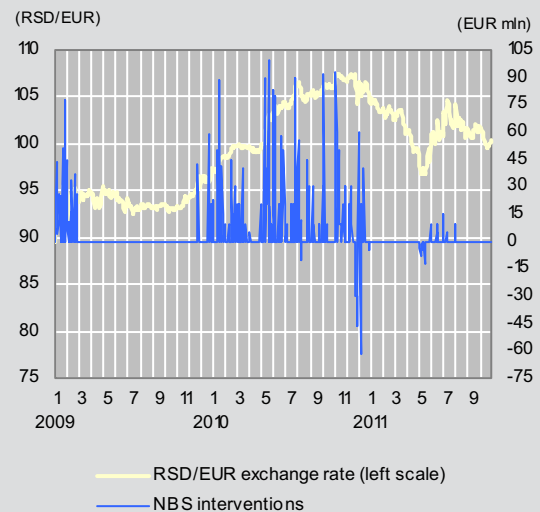
2 Movements in the foreign exchange market and the dinar exchange rate

Q3 saw relatively stable movements in the exchange rate of the dinar and an increase in liquidity of the domestic foreign exchange market.

Though early Q3 witnessed depreciation pressures, the exchange rate of the dinar stabilised by the end of July and started appreciating in early September. At the end of that month, it was stronger by 1.3% than at end-June. Overall in Q3, the exchange rate ranged from 100.3 to 104.8 dinars per euro. The dinar lost on average 2.1% against the euro and 3.8% against the US dollar. With the weakening of the nominal effective exchange rate of the dinar¹¹ (2.5%) and slower growth in domestic relative to foreign prices, the real effective exchange rate of the dinar depreciated by 2.9% (2.4% against the euro and 4.7% against the dollar).

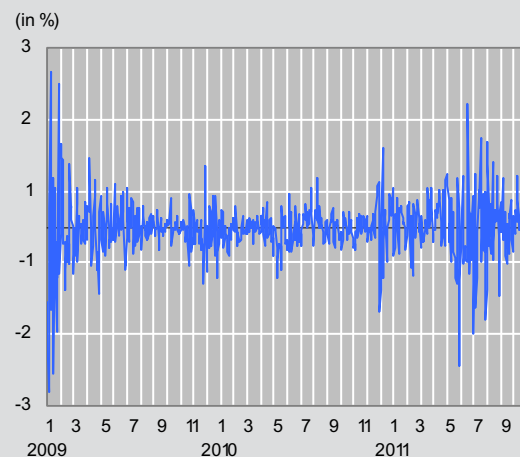
The dinar depreciated from May to July due to a rise in the country risk premium, triggered by the deepening of the euro area debt crisis. The global and regional risk premium continued rising throughout Q3, but the dinar steadied from end-July onwards, thanks mainly to capital inflows from FDI. As they financed a part of their foreign exchange payments from increased inflow of FDI, enterprises net purchased smaller amounts of foreign exchange from banks than in Q2. The inflow from net purchase from exchange offices was higher, while the inflow from foreign exchange savings was lower than a

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



The NBS intervened three times in Q3 by selling foreign currency.

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

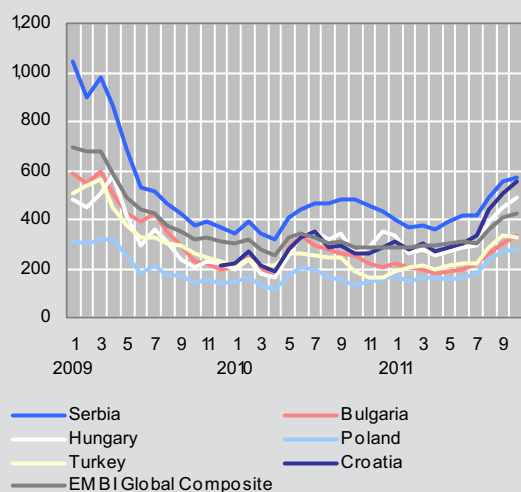


* Negative rates indicate depreciation and positive rates appreciation of the dinar.

Daily fluctuation of the dinar exchange rate gradually diminished over Q3, but remained higher than pre-May.

¹¹ Weights used: 0.8 for the euro and 0.2 for the dollar.

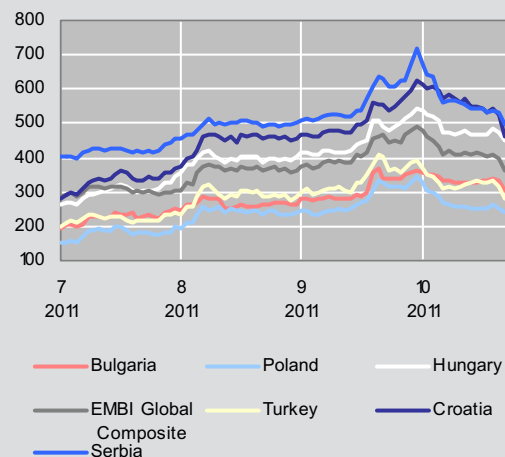
Chart IV.2.3 Risk premium indicator – EMBI by country
(monthly averages, in basis points)



Source: JP Morgan.

Risk premium continued up in Q3 in all countries observed.

Chart IV.2.4 Risk premium indicator – EMBI by country
(daily, in basis points)



Source: JP Morgan.

Following a Q3 rise, EMBI for Serbia fell in October slightly below EMBI for Hungary and touched the level of Croatian EMBI.

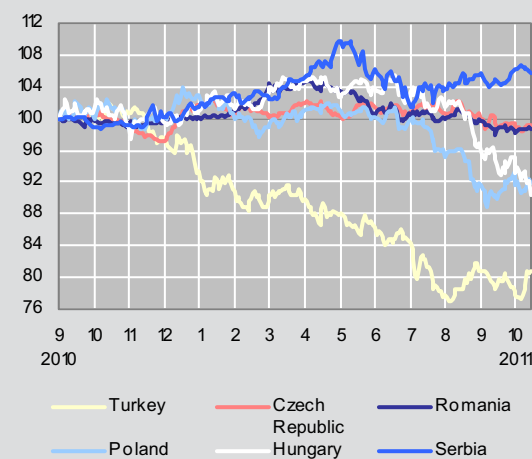
quarter earlier. Contrary to the usual practices, in August and September, non-residents acted as the net buyers of foreign exchange from banks. This, however, generated no depreciation pressures as non-residents channelled those funds into swap sale of foreign exchange to domestic banks.

Stabilisation of the dinar was also aided by the conclusion of a precautionary stand-by arrangement with the IMF. In an environment of heightened global and regional uncertainty, this arrangement provides an additional assurance in terms of safeguarding the country’s macroeconomic and financial stability. The sense of security is reinforced by the fact that Serbia has gained access to the global financial market (issue of 10-year Eurobonds of the Republic of Serbia¹²).

By contrast to the relatively stable dinar, the currencies of the majority of countries with a flexible exchange rate depreciated in Q3.

The volume of trading in the interbank foreign exchange market increased in Q3. It averaged EUR 106.2 mln¹³ per day, up by 34% on Q2 or two and a half times more than in the same period a year earlier. At monthly level, the

Chart IV.2.5 Movements in exchange rates of national currencies against the euro*
(September 30, 2010 = 100)



*Growth indicates appreciation.

Unlike most currencies of countries running flexible exchange rates, the dinar exchange rate was relatively stable in Q3.

¹² In late September, the Republic of Serbia sold its sovereign bonds in the global financial market for the first time. The issue was worth USD 1.0 bln, with a coupon rate of 7.25% and semi-annual coupon payment. The entire issue sold out at the interest rate

of 7.50% p.a. In addition to these bonds, API bonds issued in 2005 (London Club of creditors) are also available in the international market.

¹³ NBS included.

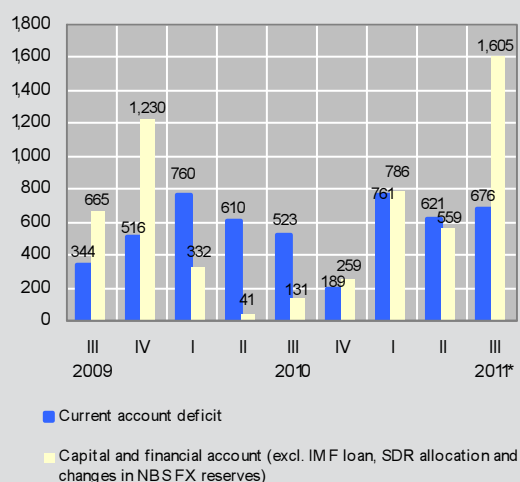
largest average daily volume was registered in July, after which it steadily declined. As the trading volumes decreased, so did the volatility of the exchange rate. Still, the exchange rate fluctuations were more pronounced than in the period leading to May. Increased daily volatility of the exchange rate of the dinar tends to stabilise capital inflows and outflows, i.e. it discourages inflow of speculative capital. The NBS intervened in the foreign exchange market three times by selling a total of EUR 30.0 mln. As banks tapped the opportunity to engage in the three-month swap transactions more than earlier, the NBS swap bought EUR 57.0 mln and sold EUR 35.0 mln.

Similar to that of other countries in the region and the global indicator, EMBI for Serbia increased. The RS Eurobonds, sold in the international market on 21 September this year, were included in the calculation of EMBI for Serbia as of 31 October. The fall of this index, begun in early October, continued after the inclusion of new bonds. At the end of the month, it came at 493 bp, somewhat lower than EMBI for Hungary and in the region of that for Croatia.

Foreign capital inflow

FDI capital inflows contributed to the stability of the dinar exchange rate.

Chart IV.2.6 Current account deficit and net capital inflow
(in EUR mln)



*Preliminary data.

Capital inflow in Q3 was ample to cover current account deficit.

Net capital inflows were much higher in Q3 than in the previous quarters. They exceeded the external financing needs and contributed to the rise in foreign exchange reserves, reflecting positively on movements in the interbank foreign exchange market and the exchange rate of the dinar.

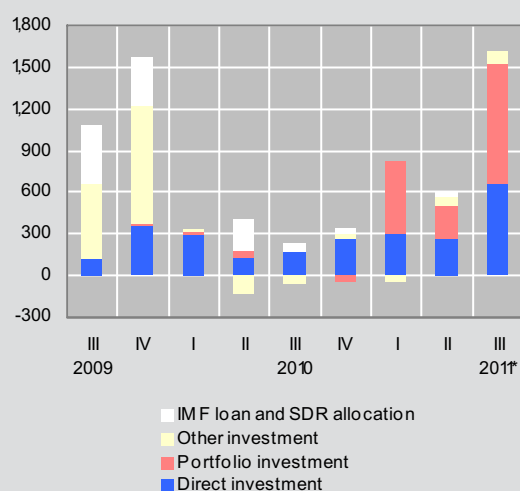
The most significant share in the structure of capital inflows was that of portfolio investment, which amounted to EUR 870.8 mln and was for the most part attributable to the successful sale of RS Eurobonds in the international market (EUR 724.3 mln). On the other hand, non-residents' investment in RS government securities in the domestic market was lower than in the quarter before.

The rise in the country risk premium had no impact on the implementation of longer-term investments agreed earlier. FDI doubled relative to the previous quarters, reaching EUR 661.2 mln. Most of this amount came through in July (EUR 419.6 mln) on account of the sale of Delta Maxi Group. Other investments were channelled into the financial sector (bank recapitalisation), retail trade and production of base metals.

Both banks and enterprises continued net repaying their foreign debt – banks by EUR 12.5 mln and enterprises by EUR 57.8 mln relative to end-Q2.

Net government borrowing increased by EUR 297.1 mln, primarily on account of the drawdown of EU

Chart IV.2.7 Structure of the financial account
(in EUR mln)



*Preliminary data.

Capital inflow from portfolio and direct investment in Q3 outstripped the levels recorded over the entire H1.

macrofinancial assistance for budget deficit financing and disbursement of government-guaranteed loans (Fiat Automobiles Serbia).

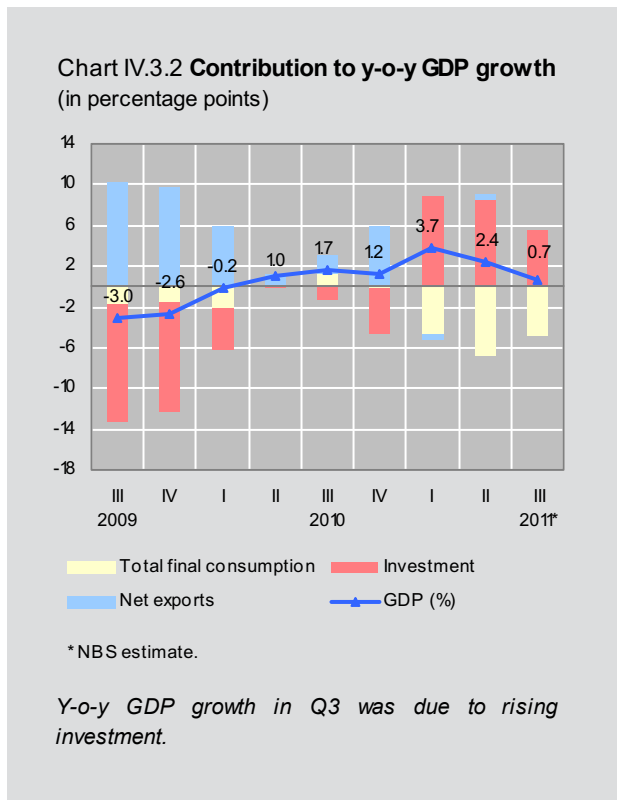
The Government of the Republic of Serbia concluded a new stand-by arrangement with the IMF. The 18-month arrangement is worth SDR 935 mln (about EUR 1.1 bln) and will be treated as precautionary, i.e. the funds will not be disbursed other than to address increased balance of payments needs.

3 Aggregate demand

It is estimated that aggregate demand in Q3 was driven down by final consumption.

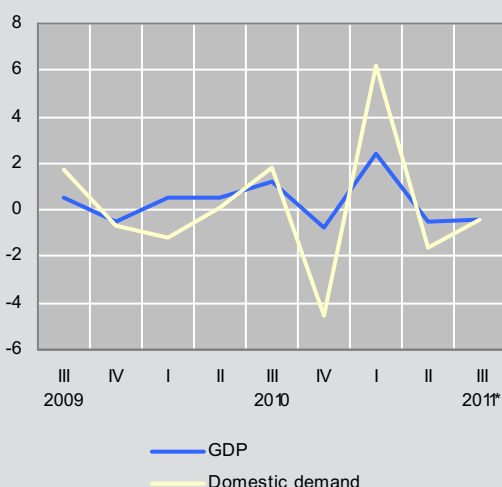
Aggregate demand saw domestic demand shrinking in Q3 and net external demand stagnating. The slump in domestic demand was due to further contraction in final consumption, both household consumption and government spending. On the other hand, fixed investments gathered momentum.

According to the RSO flash estimate, GDP slowed down suddenly in Q3 (by 0.7% y-o-y). The NBS attributes this slowdown to a cutback in final consumption, while investment activity kept the y-o-y growth positive.



The NBS projects 2011 GDP growth at around 2.0%, expecting positive impetus from investment activity and, to a lesser extent, from net exports, while final consumption is likely to give negative contribution this year as well.

Chart IV.3.1 GDP and domestic demand
(seasonally-adjusted, quarterly growth, %)



A decline in domestic demand induced a drop in GDP in Q3.

Domestic demand

Household spending

Household consumption continued to fall in Q3, albeit at a slower rate.

It is estimated that household consumption continued to sink in Q3 (-0.9% s-a), though estimated movements in real household income and retail and green market turnover pointed to some deceleration. This reflected negatively on economic activity (-0.7 pp contribution).

Household real income (wages, pensions and social benefits), the chief source of funding for consumption spending, mildly recovered in Q3 (up by 1.1% s-a). The rebound was recorded primarily in wages and, to a lesser degree, in social insurance transfers. Somewhat higher remittances additionally boosted disposable household income.

Estimates show that retail trade turnover, the key indicator of household consumption, flat-lined from the previous quarter (having gained 0.3% s-a), which confirms low purchasing power of the population.

Judging by movements in the first nine months of this year, household consumption appears very likely to negatively contribute to GDP growth this year again.

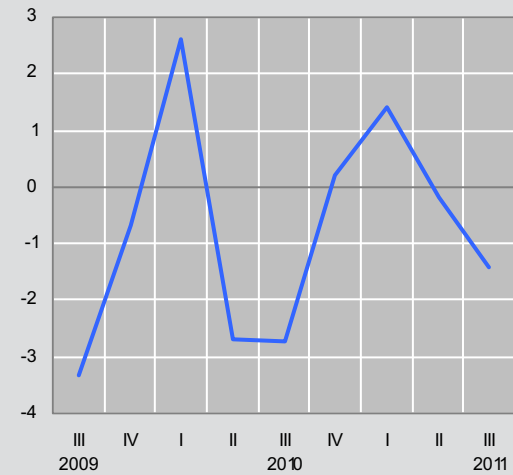
Government spending

Q3 saw a cutback in government spending relative to the previous quarter.

After stagnating in Q2, government spending fell by 1.4% s-a in real terms q-o-q, weighed down by lower outlays for goods and services. Compared to the same period a year earlier, government spending remained broadly unchanged in real terms.

With tax revenue receipts weaker than expected, October saw revisions to the 2011 republic budget, downward to revenues and upward to expenditures, by RSD 19.1 bln and RSD 3.2 bln, respectively. Consequently, and as agreed with the IMF, the consolidated budget deficit for 2011 was expanded from 4.1% to 4.5% of GDP. The budget revision planned for a 3.2% nominal increase in government spending for public administration payroll

Chart IV.3.3 **Government spending**
(seasonally-adjusted data, quarterly growth, %)



Public spending declined in Q3.

expenditures and purchase of goods and services. However, this should not have a significant impact on domestic demand trends.

Text box 2: Budget revision

When 59.5% of the Republic of Serbia’s budget deficit planned for 2011 was used up by the end of June, it became clear that unless tax revenue collection improves, budget revision would soon have to be on the government agenda. As revenue continued to lag behind expenditure in Q3, 83.6% of the deficit planned for this year was spent as early as in September. Therefore, following consultations with the IMF, the Government (in September) and the Assembly (in October) adopted the Law Amending the Law on the Republic of Serbia’s Budget for 2011.

The revised budget envisages lower revenue (by 2.6% or RSD 19.1 bln) and higher expenditure (by 0.4% or RSD 3.2 bln), i.e. higher deficit (by 15.6% or RSD 22.2 bln). Therefore, in agreement with the IMF, the cap on the consolidated budget deficit for 2011 was raised from 4.1% to 4.5% of GDP. What matters more for monetary policy than the level of the deficit itself is the way of deficit financing (domestically/externally), which determines whether the monetary effect will be expansionary or restrictive.

On the revenue side, the most important adjustment was made in respect of two major tax sources. Cuts were made for VAT (by 4.2% or RSD 14.4 bln) and personal income tax receipts (11.3% or RSD 8.0 bln), while excise revenue (by 0.9% or RSD 1.5 bln) and other tax revenue (14.6% or RSD 1.3 bln) were slightly raised.

On the expenditure side, funds were reallocated rather than increased – outlays for employees were raised (by 3.8% or RSD 7.5 bln), as well as outlays for the Pension and Disability Insurance Fund (3.1% or RSD 7.2 bln) and social welfare payments (3.5% or RSD 3.1 bln). On the other hand, capital expenditure was reduced (by 26.4% or RSD 8.4 bln), as well as interest payment expenses (7.7% or RSD 3.5 bln), outlays for the National Employment Service and other insurance funds (3.4% or RSD 1.5 bln), and transfers to other levels of authority (2.1% or RSD 1.4 bln).

The revenue structure of the new budget is dominated by VAT, excise tax and personal income tax receipts which account for 81.2% of total budget revenue (Chart O 2.1). The most important expenditure items continue to be outlays for the Pension and Disability Insurance Fund, as well as outlays for employees and social welfare payments which together make up 62.8% of budget expenditure (Chart O 2.2).

In an environment of global uncertainty regarding the sustainability of public finance, the perceived risks towards Serbia will depend primarily on the achievement of its budget objectives. Like any elections, the oncoming parliamentary and local elections in Serbia carry the risk of fiscal expansion, though the risk has been lessened by the introduction of fiscal rules and conclusion of the arrangement with the IMF.

Chart O 2.1 Structure of public revenue (%)

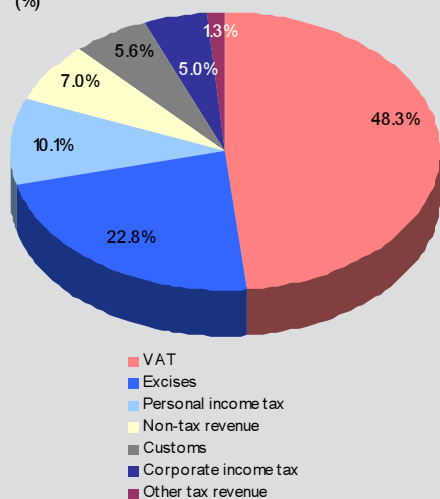
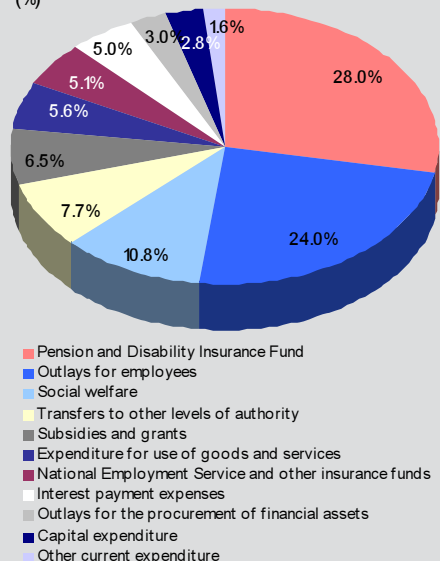


Chart O 2.2 Structure of public expenditure (%)



Source: RSM Ministry of Finance.

Investment activity

Fixed investments gained ground in Q3.

Investment activity is estimated to have picked up in Q3, both in the private and public sectors. Private sector fixed investments rose 3.8% s-a, while movements in government capital expenditures indicate a 1.3% s-a increase in public sector investment.

The upturn in fixed investments was signalled by higher imports of capital goods. As a result, fixed investments contributed 0.7 pp to GDP growth in Q3.

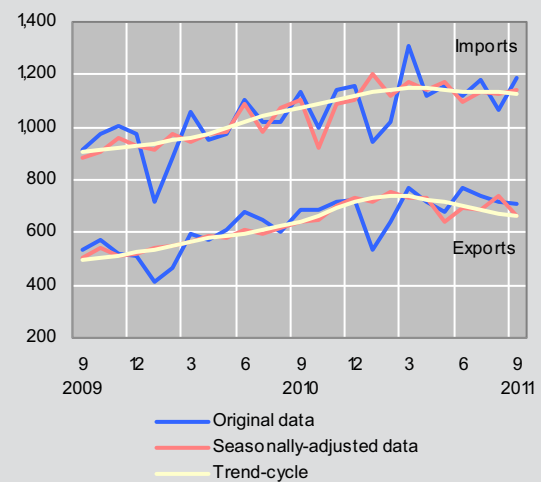
By contrast, investments in inventories were on decline. Within finished products' stocks in industry, stocks of intermediate and capital goods as well as of durable consumer goods shrunk.

Reflecting an upswing in investment activity, investment loans were approved in amounts similar to those in Q2. Larger FDI capital inflows gave an additional boost to investment.

Net external demand

Net external demand had a neutral impact on economic activity in Q3.

Chart IV.3.4 Exports and imports
(in EUR mln)



Net exports did not affect GDP movements in Q3 owing to a negligibly faster rise in exports than imports.

As s-a exports of goods and services rose negligibly faster than imports in Q3, the contribution of net exports to economic activity was literally nil.¹⁴

Table IV.3.1 Investment indicators

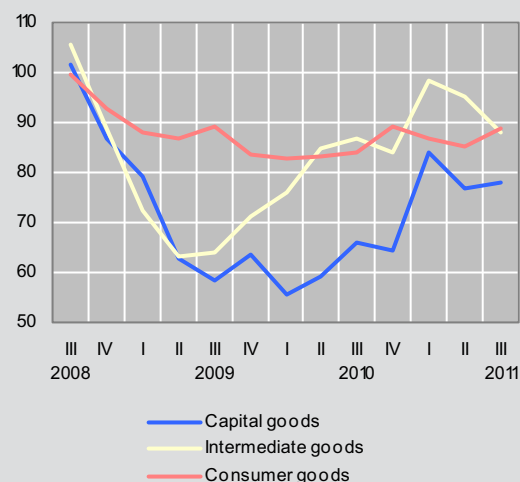
	2005-2008 (average)	2010		2011		
		III	IV	I	II	III
Real indicators						
<i>(seasonally-adjusted, quarterly, growth, in %)</i>						
Construction	2.2	1.3	1.1	0.6	3.8	-0.4 *
Industrial production of capital goods (physical volume)	-6.5	-5.0	11.8	20.4	-23.6	-8.9
Exports of capital goods**	29.3	-12.3	31.9	-16.0	-5.9	10.1
Imports of capital goods**	11.2	10.1	3.0	9.8	-12.7	6.5
Stocks of capital goods	-1.6	-6.9	-10.2	52.3	2.2	-2.6
Industrial production of intermediate goods (physical volume)	3.9	1.3	-3.8	7.7	-1.2	-2.2
Exports of intermediate goods**	17.6	2.9	7.9	8.0	-7.8	-4.1
Imports of intermediate goods**	15.4	9.4	1.9	4.2	-3.0	-5.1
Stocks of intermediate goods	0.5	0.8	-3.3	2.9	-2.9	-2.7
Government investment**	16.2	2.1	-0.5	-3.8	-0.2	1.3
Financial indicators						
Medium- and long-term external borrowing by enterprises (net, in EUR mln)	528.8	-150.2	-228.4	-213.2	-169.0	-58.5
Long-term credits to enterprises (in RSD bln)	43.3	13.5	27.1	8.9	43.6	27.7
of which: investment loans	n.a.	15.6	19.4	-6.4	7.0	11.0
Long-term credits to households (in RSD bln)	78.9	21.6	12.8	-9.1	19.9	2.0

* 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.

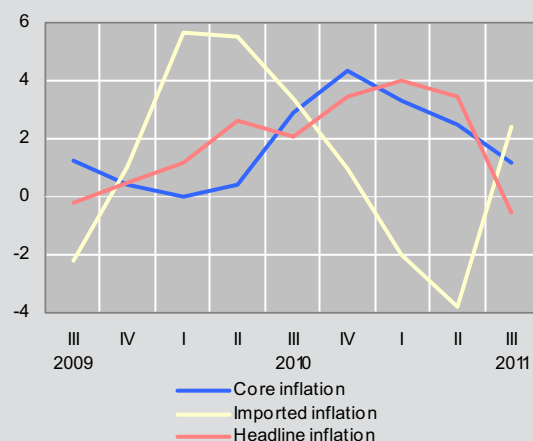
¹⁴ The reason behind is that the share of imports in GDP is significantly higher than that of exports.

Chart IV.3.5 Imports by key components
(seasonally-adjusted, 2008 = 100)



Q3 saw higher imports of equipment and consumer goods.

Chart IV.3.6 Domestic and imported inflation*
(quarterly growth rates, in %)



Sources: NBS and Eurostat.

* Ratio of averages for two consecutive quarters.

Imported inflation in Q3 was driven by the nominal effective depreciation of the dinar.

In y-o-y terms, the contribution of foreign trade to GDP growth also equalled zero as exports rose 11.9% and imports 7.9%.

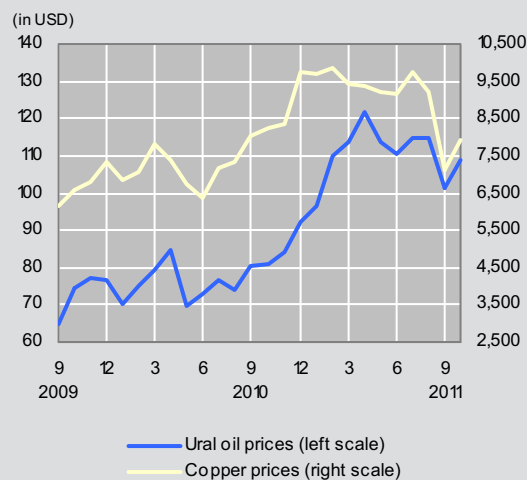
On the side of exports, growth was registered for agricultural and metal products, and a fall for base metals, notably iron and steel, and chemical products. On the side of imports, an increase was recorded for equipment and consumer products, and a decrease for intermediate goods.

At end-Q3, s-a exports were by around 4% higher and imports by around 17% lower than in the pre-crisis period¹⁵.

By contrast to the previous two quarters witnessing imported deflation, Q3 saw imported inflation of 2.4%.¹⁶ Such an outturn resulted from the depreciation of the nominal effective exchange rate of the dinar (2.5%) relative to Q2, given that prices in the EU and the United States recorded a decline in the same period (-0.1% on average). The rise in import prices did not reflect on movements in core and headline inflation in Q3.

Overall in Q3, oil prices fell by around 8%, but displayed great volatility due to the release of ever changing news and information. Investor expectations that the rescue

Chart IV.3.7 Oil and copper price movements



Source: Bloomberg.

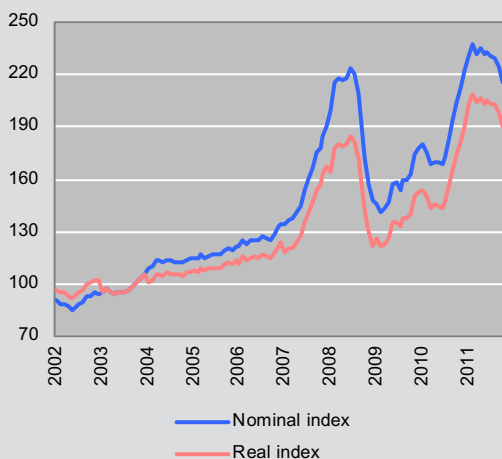
Oil and copper prices declined in Q3, only to rise in October.

package for Greece would put an end to the debt crisis sustained oil prices at relatively lofty levels throughout July. In the first half of August, however, they dipped

¹⁵ January–September 2008.

¹⁶ Ratio of averages for two consecutive quarters.

Chart IV.3.8 **World food price index**
(2002 - 2004 = 100)



Source: FAO, UN.

Though declining in Q3 and October, world food prices remained at a relatively high level.

down on the release of data on lower than expected growth of the US economy, a downgrade in their credit rating and an increase in oil inventories. The Fed's measures to stimulate economic growth and the ECB's purchase of sovereign bonds to ease financial market stress in the euro area, rekindled oil prices, sending them upwards. In fact, they were on the rise all the way until late September when bad news from Europe and forecasts of a slow and protracted US recovery dampened the demand for oil and weighed down on its prices. Oil price volatility continued in October. Looking forward, oil price movements will depend most on the efficient resolution of the euro area crisis and the pace of US economic recovery.

Copper prices followed a similar pattern and recorded a decline in Q3 (23%). From high July levels, red metal prices dropped temporarily in the first half of August, only to surge back to more than USD 9,000 per tonne at the end of the month. Most of the Q3 fall (as much as 22%) unfolded in September for reasons similar to those driving the fall in oil prices. The demand for copper is affected by the global slowdown in economic activity, while its prices are also under the impact of a cutback in

China's imports, China being the world's largest copper consumer. The price of copper rebounded in October and ended the month around 10% higher than at end-Q3 as a result of rising demand, propelled by greater investor optimism, lower risk aversion, and the weakening of the dollar.

As indicated by the FAO Food Price Index, global food prices fell by around 3.5% in Q3. About 2% of this fall took place in September reflecting the drop in prices of the majority of primary commodities, and most of all sugar, cereals, and oils and fats. Global food prices continued down in October, hitting an 11-month low. This notwithstanding, food prices remain relatively high. In the coming period, they are likely to decline further, as well as to exhibit a greater degree of volatility due to global economic uncertainty and the still relatively low level of grain reserves.

4 Economic activity

Economic activity is estimated to have slowed further in Q3, as negative output gap widened.

GDP is estimated to have shrunk in Q2 (-0.5% s-a)¹⁷, mainly due to deceleration in trade and manufacturing sector. As a consequence NAVA also declined by 0.4% s-a.¹⁸

According to the RSO's flash estimate, Q3 GDP slackened its pace to 0.7% y-o-y. Economic activity is thus estimated to have continued on its downward path (GDP dropped by 0.4% s-a and NAVA by 0.6% s-a), remaining below its pre-crisis level.¹⁹

The downward pressure in Q3 came from a cutback in industrial production and further slump in wholesale and retail trade (each contributing by -0.2 pp). A bulk of the service sectors and agriculture, however, pushed in the opposite direction.

The Q3 fall in industrial production was mostly driven by the squeeze in manufacturing (2.2% s-a) and further depressed by the fall of activity in the remaining two sectors – electricity, gas and steam supply²⁰ (2.6% s-a) and mining (4.6% s-a).

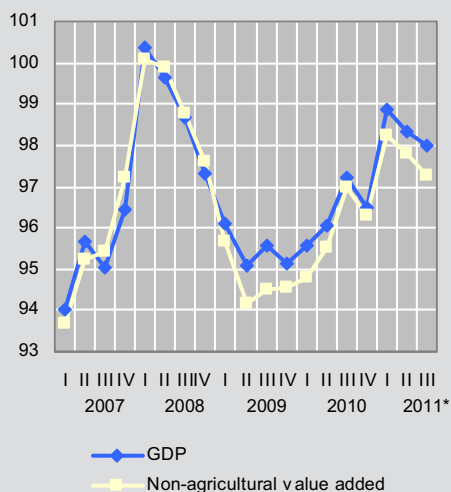
¹⁷ According to the RSO data, it fell by 0.1% s-a.

¹⁸ Observed y-o-y, GDP and NAVA slowed down in Q2 to 2.4% and 1.4%, respectively.

¹⁹ Pre-crisis period is considered to be H1 2008.

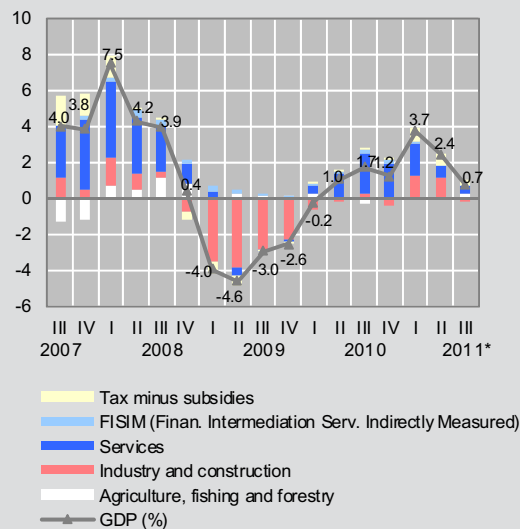
²⁰ According to the new classification of economic activities, this is Sector D – Electricity, gas, steam and air-conditioning supply.

Chart IV.4.1 Economic activity indicators
(seasonally-adjusted data, Q1 2008 = 100)



* NBS estimate.
GDP and NAVA fell in Q3.

Chart IV.4.2 Contribution to y-o-y GDP growth
(in p. p.)



* NBS estimate.
Y-o-y economic growth slowed mildly in Q3.

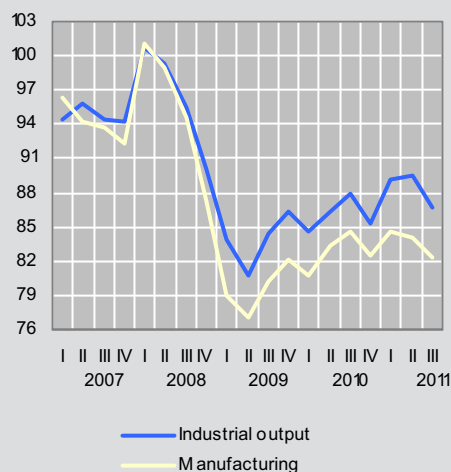
Manufacturing saw shrinking in base metals, coke and refined petroleum products, machinery and equipment, as well as food products and beverages. Food and beverages production suffered largely from accumulated problems in struggling to maintain price competitiveness of confectionery industry²¹, and low domestic demand. Rallying sectors in manufacturing in Q3 were the production of tobacco products, rubber and plastics, paper and paper products.

According to estimates, wholesale and retail trade continued to dwindle in Q3 (1.9% s-a). Despite a rebound in real household income, retail trade was broadly flat. This may be a signal of household consumption being redirected toward cheaper sources of supply²², as well as into grey economy.

Construction lost the momentum gathered in Q2 and went down by 0.4% s-a, as signalled by a decline in non-metallic minerals production (cement, roof tiles, tiles and glass) and an estimated drop-off in effective work hours.

Sectors estimated to have ramped up activity are transportation and storage (primarily freight transport),

Chart IV.4.3 Industrial output
(seasonally-adjusted data, H1 2008 = 100)



A fall in industrial production in Q3 was mainly due to a contraction in manufacturing.

financial sector, real estate and majority of other service sectors. Assumptions underlying the estimated upswing in

²¹ Domestic producers have for a longer period coped with costly raw materials on the one hand and weakening of consumers' purchasing power and highly liberalized confectionery import on the other.

²² Turnover of agricultural products in green markets is estimated to have intensified in Q3.

agricultural output are better agricultural season this year and expected expansion of fruit production (plums, apples, raspberries, walnuts, sour cherries, pears), vegetables, wheat²³ and sunflower.

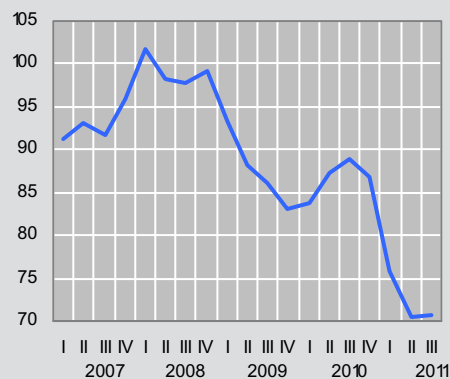
In 2011, GDP should expand by around 2.0%, largely on the back of stronger industrial production and

acceleration in the sectors of information and communication, transportation and storage, and construction.

Negative output gap is estimated to have widened in Q3, a signal that strong disinflationary pressures stemming from aggregate demand have remained.

Chart IV.4.4 **Retail trade**

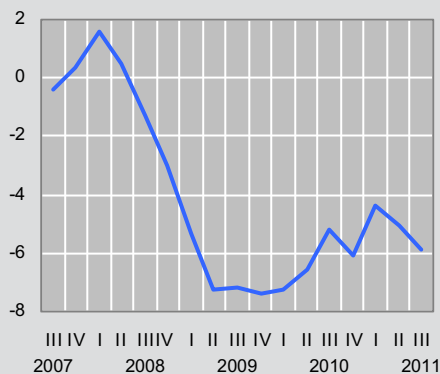
(seasonally-adjusted data, H1 2008 = 100)



Retail trade stagnated in Q3.

Chart IV.4.5 **Output gap***

(percentual deviation from the trend)



* NBS estimate.

Output gap deepened in Q3.

5 Labour market developments

Wages

Q3 saw a step-up in net wages, both in nominal and real terms, as industrial unit labour costs increased.

According to seasonally-adjusted data, net wages went up by 2.8% in nominal and 2.1% in real terms in Q3, growing faster in the private than the public sector (real s-a growth was 4.2% and 0.8%, respectively).

Net wage growth was registered in most industries, with greatest real increases attributed to wholesale and retail trade, information and communication, and electricity, gas and steam supply.

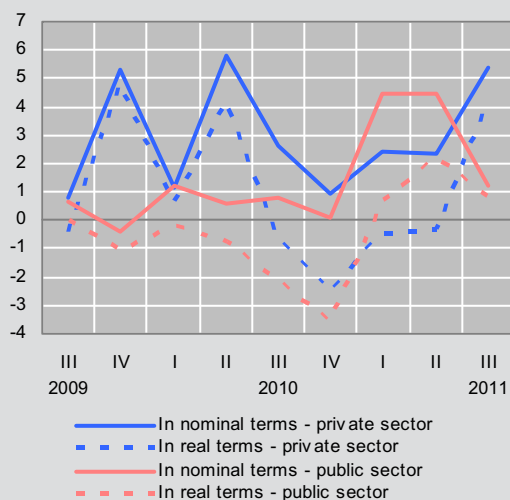
Observed y-o-y, nominal wages accelerated slightly (12.8%), reflecting faster growth of both private and public sector wages (12.9% and 10.6%, respectively). The 2.0% real wage growth relative to the same period of the year earlier was driven by the private sector wages (2.1% y-o-y), since those in the public sector stagnated (0.0% y-o-y).

The average net wage paid out in Serbia in Q3 equalled RSD 38,759.

Industrial unit labour costs continued to soar, the upward pressure coming from lower labour productivity and higher gross real wages. Industry-wise, the pressure originated primarily from the rising costs in the manufacture of other means of transport, base metals and chemicals and chemical products. Manufacturing also experienced an increase in unit labour costs in the third quarter.

²³ 2011 saw one of the highest wheat yields per hectare in the last twenty years.

Chart IV.5.1 Average net wages
(seasonally-adjusted data, quarterly growth, in %)



Net wages rose more in the private than public sector in Q3.

Employment

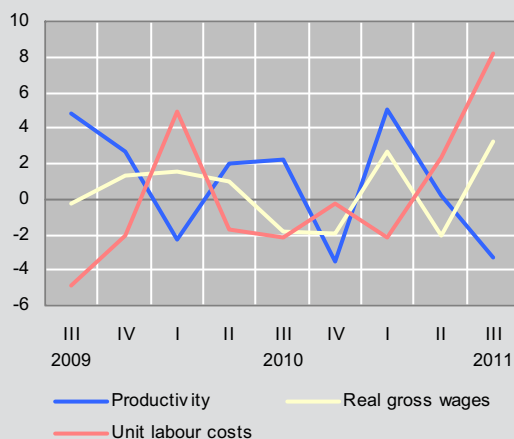
Labour market continued to offer a bleak picture, with employment numbers flat-lining in Q3.

With only small changes in the number of employees across all industries, employment numbers were near a stand-still relative to Q2 (576 fewer employees). Shrinking employment numbers in the public sector and construction (1,663 persons in total, - 0.1 pp contribution to total employment) were largely offset by a positive impetus from services and industry, most notably manufacturing.

Within the public sector, only public administration and compulsory social insurance saw employment increases, while other activities (health care and social protection, administrative activities, education) recorded a decline.

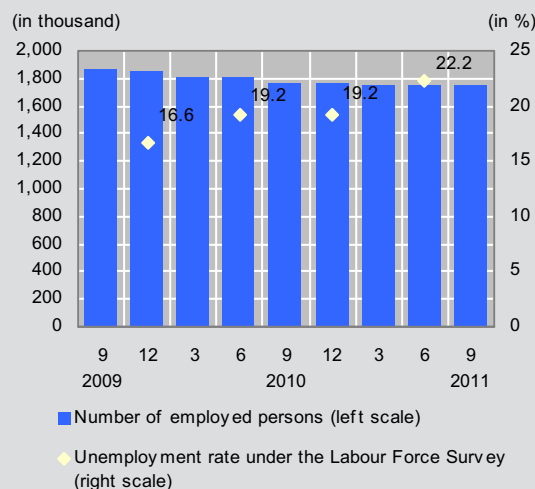
Relative to the same period last year, the drop in employment continued to lose steam in Q3, from 3.1% to 1.1%, owing to a slower reduction in the number of

Chart IV.5.2 Movements in productivity, real gross wages and unit labour costs in the industry
(seasonally-adjusted data, quarterly growth, in %)



Unit labour costs in the industry continued to rise in Q3.

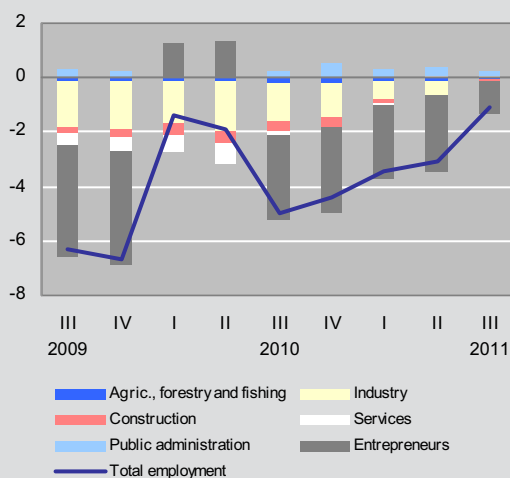
Chart IV.5.3 Unemployment



Source: Serbian Statistical Office.

Employment numbers remained unchanged in Q3.

Chart IV.5.4 Employment by sector
(contribution to y-o-y growth in employment, in p.p.)



Source: Serbian Statistical Office.

A y-o-y decline in employment continued to slow in Q3.

entrepreneurs and growth in the number of employees in manufacturing, trade and education.

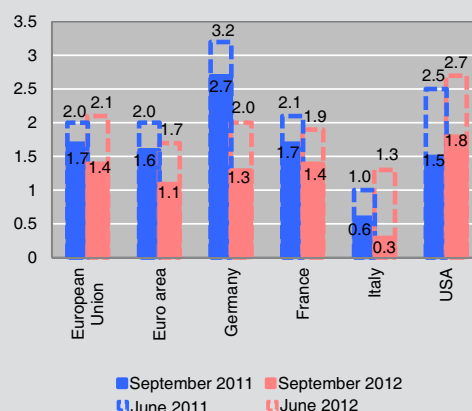
According to the National Employment Service data, the new employment in Q3 was 18,000 persons or 8.3% stronger than the quarter before. A decline in registered unemployment decelerated accordingly. By the end of Q3, the unemployment figure levelled at 743,000, which is a 1.8% decrease compared to June. The trends however remain discouraging, as illustrated by the still growing number of unemployed persons per vacancy – 175 unemployed per a job opening at end-Q3 marked a 20.3% increase on end-Q2. According to the April Labour Force Survey (conducted by the RSO), unemployment rate stood high in April (22.2%), and sluggish recovery of economic activity and low flexibility of the Serbian labour market do not offer a promise of any significant improvements for the October survey.²⁴

6 International environment

In Q3, international environment was marked by heightened tensions over euro area public debt crisis.

²⁴ The Survey is conducted semi-annually. The findings of the October survey will be published in December.

Chart IV.6.1 Revisions of forecasts of real GDP growth for the current and next year, for the EU and USA*
(%)



* Revision relative to the June *World Economic Outlook*.

Source: IMF WEO, June and September 2011.

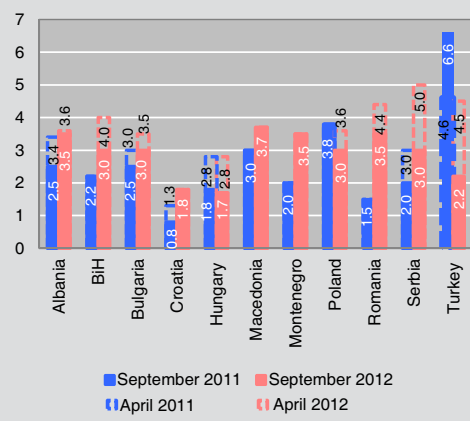
The forecast of real GDP growth for 2011 and 2012 was revised downward in September for most developed countries.

The pace of global economic recovery is slowing. Fiscal and financial uncertainties have increased sharply since August, driven primarily by concerns over public debt crisis in the euro area periphery. In consequence, most countries are having their growth forecasts for this and the next year revised downwards. Downside risks to the outlook are rising, and the possibility of a relapse into recession cannot be excluded.

Continuing public debt crisis in peripheral euro area countries has raised concerns over the exposure of other countries to their sovereign debt and heightened the fears of contagion. Though numerous measures were taken in Q3 (extended purchase of peripheral sovereign bonds by the ECB, July stress-testing – passed by 82 of the 90 banks tested, approval of the extended rescue package for Greece), investor concerns remain unabated.

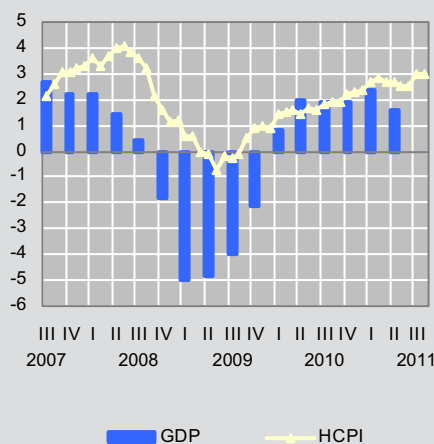
Instability of the US business environment and a US credit rating downgrade, as well as economic troubles in the euro area, have brought into question the recovery of the US economy in the coming period. Besides, US fiscal consolidation remains uncertain, and the labour market has shown no major improvement yet. According to the advance estimate of the US Bureau of Economic

Chart IV.6.2 Revisions of forecasts of real GDP growth for the current and next year for countries in the region*
(%)



* Revision relative to the April *World Economic Outlook*.
Source: IMF WEO, April and September 2011.
The forecast of real GDP growth for 2011 and 2012 was revised downward in September for most countries observed.

Chart IV.6.3 Eurozone GDP and inflation (y-o-y growth rates)



Source: Eurostat.
Inflationary pressures, depressed in Q2, strengthened by the end of Q3.

Analysis, GDP accelerated from 1.3% s-a in Q2 to 2.5% in Q3 (at an annual rate).

Concerns about the future turn of developments, primarily in the euro area, reflected on financial markets. Stock markets in advanced countries dipped down (the S&P 500 lost 14% in Q3), and yields on sovereign bonds increased not only for countries participating in the EFSF programme (Greece, Ireland and Portugal), but also for other countries to which the tensions have spread (Italy and Spain). Elevated risks for these countries are also confirmed by the downgrade in their credit ratings. In line with these movements, global risk aversion increased and, gauged by the VIX index²⁵, came close to its 12-month high.

After falling in July and stagnating in August (at 2.5%), euro area inflation jumped to 3% y-o-y in September. There were two upward revisions of the ECB’s main interest rate this year, by a total of 50 bp. In early November, however, the ECB trimmed the main rate down by 25 bp because of the imminent risk of slipping into recession, noting however that such a move would not threaten the stability of prices. Though receding, inflationary pressures persist in the United States, too. Low core inflation enables the Fed

not to tighten its monetary policy, all the more so in view of relatively slow growth and high unemployment. In fact, the Fed announced it would keep its policy rate on hold until mid-2013. Changing the maturity structure of its portfolio towards a greater share of long-term securities (so-called Operation Twist) is expected to induce a decline in long-term interest rates.

Inflationary pressures in Central and East European countries subsided in Q3. Weaker export demand and slower economic activity looming large, these countries are not likely to tighten their monetary policies in the foreseeable future.

The USD/EUR exchange rate was maintained at a relatively low level for the greater part of Q3, reflecting tightening in the ECB’s monetary stance and expectations of a solution to the debt crisis in the euro area periphery. In September, however, the dollar marked noticeable gains in response to increased fiscal and financial uncertainty in the euro area and heightened fears of another bout of recession. The strengthening of the greenback was also aided by market expectations of the onset of monetary easing by the ECB. Already in October the dollar fell back, reflecting greater investor optimism

²⁵ VIX index (Chicago Board Option Exchange (CBOE) Volatility Index) measures the volatility of S&P 500 index based on market expectations with regard to movements in the prices of shares in the coming 30 days.

regarding the resolution of the euro area debt crisis. For the major part of Q3, both the dollar and the euro weakened against the Swiss franc, one of the safe haven currencies. Following expansionary measures which failed to exert any major impact on the value of the franc, and in order to protect the domestic economy, the Swiss National Bank announced in early September it would no longer tolerate further overvaluation of its currency, i.e. strengthening of the franc above 1.20 CHF/EUR.

Concerns about public debt sustainability of some sovereign issuers and increased risk aversion made investors turn to gold as a traditional safe haven. As a result, the price of gold recorded a hefty rise in Q3, hitting in early September its historical high of 1,895 USD/Oz. Still, with the restored investor optimism in the second half of September, and the strengthening of the dollar, the price of gold retreated, ending the quarter at 1,620 USD/Oz.

The rise in investor optimism by the end of Q3 proved only partly founded. In late October, European leaders reached an agreement on the steps to resolve the Greek crisis – 50% voluntary write-down of Greek government debt by banks²⁶, recapitalisation of banks²⁷, and boosting the firepower of the EFSF (according to some estimates, the region's rescue fund could quadruple or quintuple, exceeding EUR 1,000 bln). The EFSF would retain its guarantee role, which could be of use for countries such as Italy²⁸ and Spain. Current social unrest and political uncertainty in Greece, however, pose significant constraints on the implementation of this bailout package. Embarking on an unlimited purchase of sovereign bonds by the ECB, i.e. acting as the lender of last resort is floated as one the ways to appease the crisis in financial markets.

²⁶ This would reduce total Greek debt by EUR 100 bln and help lower the share of public debt in GDP to a sustainable level by 2020 (from the current 162% to 120%).

²⁷ Banks will be required to raise their capital adequacy ratio by mid-2012 from the current 8% to 9%. According to estimates, banks will have to raise around EUR 106 bln in capital.

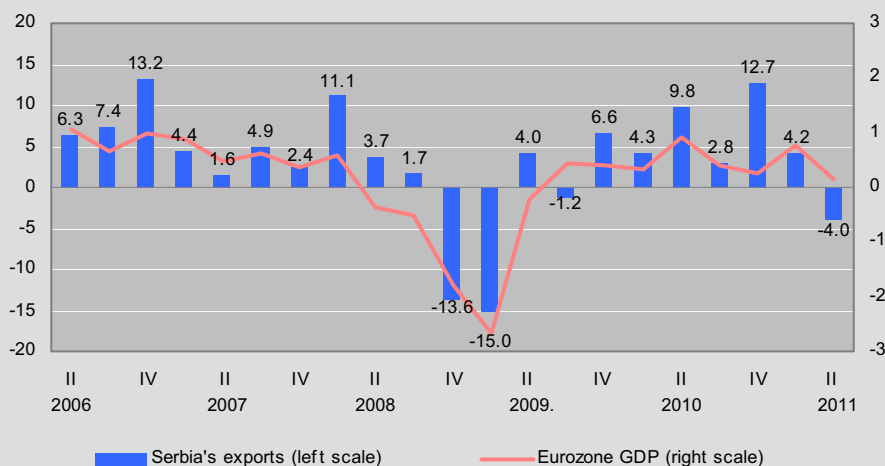
²⁸ In the first ten days of November, yields on Italian sovereign bonds were record high (over 7%).

Text box 3: Impact of the euro area economic crisis on Serbia

Heightened concerns over the outcome of the euro area debt crisis dented its economic growth forecast. The deceleration started already in Q2, with Germany’s economy losing steam (from 1.3% s-a to 0.1% s-a) and Italy’s growing only at an anaemic rate (0.3% s-a). Taking into account the downward revisions to 2011 and 2012 growth forecasts which are ongoing across the board, especially in euro area countries, and the resulting cutback in Serbia’s external demand, we have revised our GDP growth projections to around 2.0% in 2011 and around 1.5% in 2012.

According to the NBS estimates, further slackening of activity in the euro area will primarily affect Serbia’s exports, 40% of which is targeted to these markets. High dependence of Serbian exports on the economic situation in the euro area is illustrated by a relatively high unconditional correlation coefficient (0.63¹) between Serbia’s export and the euro area GDP (see Chart O.3.1). But at the end of the day, the impact on Serbia’s exports will depend on how hard the crisis hits individual euro area countries (primarily our key export partners – Italy and Germany), and on the competitiveness of domestic exports.

Chart O 3.1 **Movements in Serbia's exports and euro area economic activity**
(s-a growth rates, %)



Sources: NBS and Eurostat.

Adverse effects of the euro area crisis might also feed through the credit channel, i.e. through elevated interest rates amid growing country risk premium and more limited access to foreign sources of funding. Furthermore, not only portfolio, but foreign direct investments (projected at EUR 1.6 bln in 2012) could also be affected by the crisis.

The NBS assesses that Serbia’s banking sector is well protected and not likely to be strongly affected by the euro area disturbances. First of all, direct exposure of our banks to the euro area crisis is rather low, with “Greek” banks² holding 16% in the total banking sector assets and all banks in Serbia being independent legal entities operating in compliance with the Law on Banks and other relevant regulations. Also, not only that our banks do not hold sovereign bonds of debt-laden

¹ Unconditional coefficient of correlation between Serbia’s exports and the euro area GDP is calculated according to methodology applied by Forbes and Rigobond (2002), “No Contagion, Only Interdependence: Measuring Stock Market Co-Movements”, Journal of Finance, Vol. LVII No.5, pp. 2223-2261:

$$\rho = \frac{\rho^*}{\sqrt{1 + \delta[1 - (\rho^*)^2]}}$$
; $\delta = \frac{\sigma_c}{\sigma_t} - 1$, ρ is unconditional coefficient of correlation, ρ^* is conditional coefficient of correlation, σ_c is standard deviation of the euro area GDP in the crisis period, and σ_t is standard deviation of the euro area GDP in the pre-crisis period.

² Banks majority-owned by foreign legal persons from Greece.

euro area countries, but the share of foreign securities in their portfolios is negligible. Second, Serbia's banking sector is highly capitalized and liquid as measured by international standards.³ Third, our banks are ever more reliant on domestic sources of funding, primarily foreign currency savings of citizens, which reached EUR 7.5 bln at end-September (vs. EUR 4.8 bln in December 2008). Plus, maturity structure of their external sources of funding is very favourable – the share of short-term debt in total banks' debt decreased nearly two and a half times since end-2009 (39.7%), reaching 16.2% in August. Short-term borrowing from parent banks accounts for 3% of their total debt. Banks' borrowing from international financial organizations and development banks founded by foreign states, which constitute a stable source of funding, rose from EUR 642.8 mln in June 2010 to EUR 1.0 bln in September 2011.

Although potential negative effects in terms of higher NPL share in total loans cannot be excluded, banks' loan loss reserves provide more than sufficient coverage for NPLs.⁴ Therefore, credit channel is the main channel through which the euro area crisis could feed through into our banking sector.

³ Capital adequacy ratio stood at 19.7% at end-September, while the Basel Committee prescribes a minimum of 8%. High capitalization is a result of relatively conservative regulations of the NBS. Average regulatory liquidity ratio at end-Q3 equalled 2.1.

⁴ At end-Q3 of 2011, loan loss reserveratio was 128.2%.

V Inflation projection

Y-o-y inflation will continue down in the coming months and is expected to retreat within the target in Q1 2012, staying within the target band thereafter. The key disinflationary factor in the medium term will be low aggregate demand. The drop in inflation expectations will also play a role. Due to the deteriorating global outlook, our GDP growth forecasts have been revised down.

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 assumes an active monetary policy which aims to keep inflation within the target tolerance band in the medium run and thus fulfil its principal role as defined by the current monetary policy framework.

Initial conditions

In line with our expectations, inflation recorded a 0.4% decline in Q3, returning to single digits in y-o-y terms – from 12.7% in June to 9.3% in September. The strongest disinflationary effects came from the sharper than seasonally expected drop in fruit and vegetable prices (23.4%).

Core inflation was somewhat higher than a quarter earlier, reflecting accelerated growth in prices of non-food products and services. The food component of core inflation was lower than in Q2, while the growth in administered and petroleum product prices recorded in Q3 was weaker than in H1 2011.

Since the last *Inflation Report*, the global financial market has seen an increase in investor pessimism, driven by concerns over fiscal consolidation of some euro area members. Growing pessimism has led to a downfall in prices of primary commodities (oil, base metals and agricultural products), which helped ease inflationary pressures.

Financial shocks spilled over from the world stock markets to Serbia primarily through the rise in the country risk premium. Measured by EMBI, the country risk premium reached maximum 717 bp in early October. By the end of the month, EMBI fell back to 493 bp, but remained higher by around 100 bp than at the start of Q3.

By contrast to other regional currencies which depreciated, the dinar was relatively stable in Q3, reflecting chiefly the FDI inflow, conclusion of a precautionary stand-by arrangement with the IMF, and Serbia's access to the global financial market (sale of 10-year RS Eurobonds).

Nominal depreciation of the dinar (Q3 average relative to Q2 average) and a faster drop in domestic relative to foreign prices led to an increase in net importers' real marginal costs. However, as they remain relatively low, no upward pressure on domestic prices is expected in this respect.

Entrenched at 8.0% for six consecutive months, inflation expectations of the financial sector fell to 7.0% in October and further down to 6.7% in November, most probably as a result of a continuous fall in y-o-y inflation rates in the previous five months.

Following stagnation in Q2, economic activity declined in Q3 by 0.4% s-a. Y-o-y, growth slowed from 2.4% in Q2 to 0.7% in Q3. Serbia's GDP growth projections were scaled down to around 2.0% for 2011 and 1.5% for 2012.

The continuing fall in economic activity, as well as negative output gap, indicate that aggregate demand is low, and as such, likely to be the key disinflationary factor in the medium term.

The euro area economy slowed down in Q2, and similar trends are expected in the period ahead. Public debt woes of some of its members caused a downward revision of growth projections for 2011 and 2012 for the entire region. Growth forecasts for most CEFTA countries were also trimmed down. Given the high share of these countries in our foreign trade, the implication for Serbia will be lower export demand.

As inflationary pressures receded, the key policy rate was lowered from June to November by 200 bp, to 10.0%.

Projection assumptions

This year again, administered prices rose more than planned, hampering inflation's return within the target band. Their growth in 2012 is expected to be lower and supportive of the disinflation process.

After falling for two consecutive quarters, fruit and vegetable prices are low at the moment, and are therefore assumed to grow faster than other market prices next year, even in the event of average agricultural performance.

Due to the lowering of euro area growth projections for 2011 and 2012, and expectations that inflation would return close to the target in 2012, the ECB started to ease its monetary policy in Q4 and is most likely to continue along that path in the period ahead.

Inflation projection

Inflation will continue retreating over the coming months and is expected to return within the target in Q1 2012, where it will stay for the rest of the projection horizon.

In the medium term, the strongest disinflationary pressures will come from low aggregate demand. Over the entire projection horizon, aggregate demand has a distinctly disinflationary impact, reflecting primarily deteriorating growth prospects for the euro area and the neighbouring countries.

The cost-push pressure on food prices is expected to lessen in the wake of a decline in prices of primary agricultural commodities. On the other hand, as they are currently low thanks to good agricultural performance this year, fruit and vegetable prices are expected to grow faster than other prices once the new agricultural season sets in.

The prices of non-food products will grow at a slower pace until the end of the year and during 2012. Given the anticipated slackening of the global economy and the consequent fall in crude oil prices, no inflationary pressure is likely to be generated by the petroleum product prices either.

As regards administered prices, the last quarter of the year will see an increase in prices of natural gas, heating and public transportation services. In 2012, administered prices are expected to grow at a slower pace.

Net importers' marginal costs remain low. This factor is expected to have a disinflationary effect for some time yet.

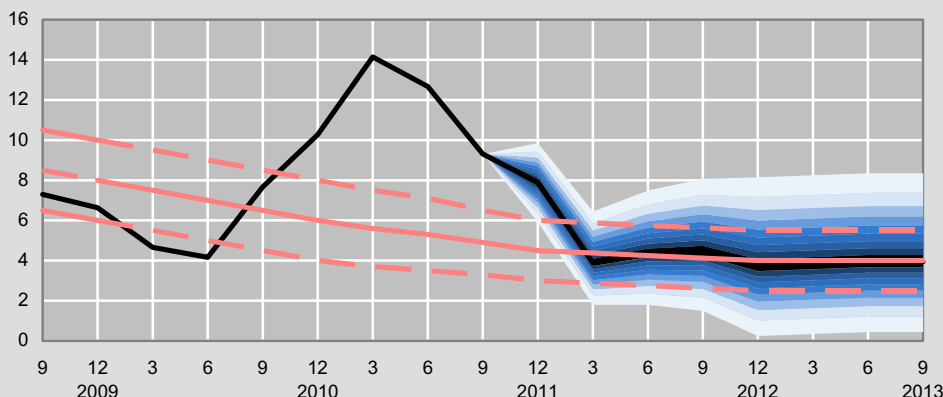
The process of disinflation will be supported by the further drop in inflation expectations. Once inflation returns within the target band in Q1 2012, expectations are likely to follow suit.

Looking ahead, depressed aggregate demand, net importers' low marginal costs and lower inflation

Table V.0.1 **Projection assumptions**

	2011	2012
External assumptions		
EU inflation (Q4 to Q4)	2.5%	1.7%
ECB policy rate (year-end)	1.25%	1.00%
Euro area GDP growth	1.6%	0.0%
Ural oil price per barrel (year-end, USD)	107	112
Internal assumptions		
Administered prices (Dec to Dec)	10.5%	7.4%
Fruit and vegetable prices (Dec to Dec)	3.8%	5.0%
Trends		
Appreciation trend of the real exchange rate (average)	1.7%	2.0%
Real interest rate trend (average)	4.6%	4.3%

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



Inflation will continue down in Q4 2011 and will return within the target band in Q1 2012, revolving around the target midpoint thereafter. The projection band is tilted to the upside due to the possibility of spill-over of public debt crisis in some advanced economies to Serbia and the rise in country risk premium.

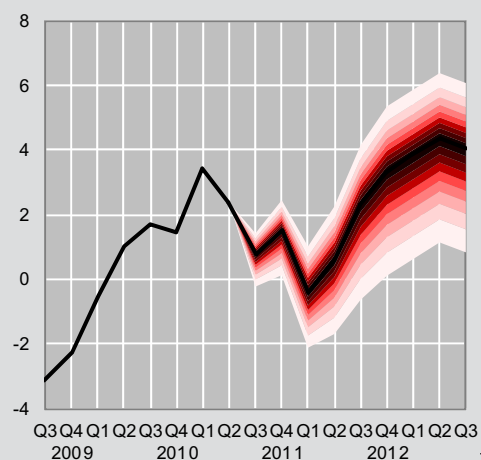
The fan chart depicts probability of various inflation outcomes in the next eight quarters. Central projection is within the darkest central band and the probability that inflation would lie in it is 10%. Outturns of inflation are also expected to lie somewhere within the entire fan chart with probability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

expectations will keep monthly inflation rates at bay. A significant contribution to the drop in y-o-y inflation rates will also come from the base effect, i.e. gradual exclusion of the hefty price hikes of late 2010 and early 2011 from the calculation of y-o-y inflation and inclusion of new, lower monthly inflation rates.

Following stagnation in Q2, economic activity recorded a decline in Q3. Overall, growth in 2011 will be lower than expected earlier due to the weaker growth of our key trading partners (Italy, Germany, BiH, Montenegro, Romania).

For that same reason, 2012 is also poised for lower economic growth than projected in the *August Report*. Although we anticipate slower investment in the coming year, the effects of investments already underway, notably those in the automotive and oil industry, will only begin to reflect on the growth in output and exports. Economic growth will continue to be relatively modest in the year ahead, and so will the growth in domestic final consumption and, by extension, imports.

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



The Serbian economy will grow modestly in the coming period due to the worsening in growth prospects for the euro area.

Risks to the projection

The key risks to inflation projection are associated with movements in the international environment and potential fiscal expansion at home.

Heightened investor worries over fiscal consolidation of some advanced economies fed through into higher country risk premiums throughout the region. Any further investor distrust and the rise in risk premium on that account could dampen capital inflows and, potentially, give rise to depreciation pressures.

On the other hand, if contrary to prevailing expectations, the global economy enters a new recession, the disinflationary effects of low aggregate demand will be stronger than assumed in the projection.

The problem of public debt sustainability of some advanced countries has made investors more alert to fiscal

stability indicators. The new precautionary arrangement with the IMF is therefore of paramount importance for Serbia. Still, any major deviation of the budget deficit from the level planned could push up public debt and the risk premium, thereby generating inflationary pressures.

On balance, the potential inflationary effects of higher risk premium and fiscal expansion are judged to outweigh the disinflationary effects of low aggregate demand, wherefore risks to the projected path for inflation are skewed slightly to the upside.

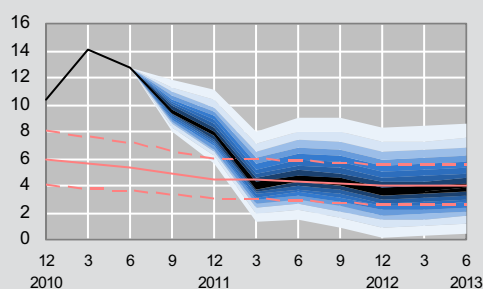
Comparison with the previous projection

The projected spread of inflation outcomes for H1 2012 is lower than in the August Report, primarily due to the stronger disinflationary impact of aggregate demand. Looking further ahead, the projection proceeds along more or less the same lines.

Chart V.0.3 Current vs. previous projection

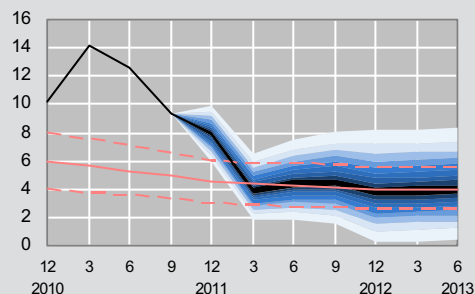
August projection

(y-o-y rates, in %)



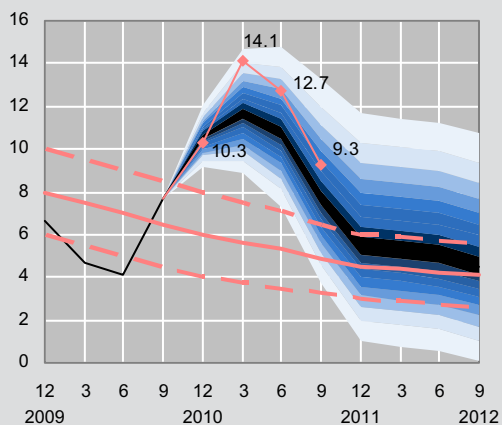
November projection

(y-o-y rates, in %)



The projected spread of inflation outcomes is lower than in the August Report for H1 2012, but similar further ahead.

Chart V.0.4 Inflation outturn vs. November 2010 inflation projection
(y-o-y rates, in %)



From the onset of 2011, inflation moved above the midpoint but within the projection band stated in the November 2010 Inflation Report.

As marked turbulence in the international environment over the last several months has led to a downward revision of global economic growth forecasts, aggregate demand in Serbia is assumed to have stronger disinflationary impact than in August.

From the onset of 2011, inflation moved above the midpoint but within the projection band stated in the November 2010 *Inflation Report*. The main reason for this departure from the projected trajectory was the stronger than expected growth in food and administered prices in late 2010 and early 2011.

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 the key policy rate is more likely to be lowered in the coming period rather than raised or kept on hold (10.0%).

Table A
Indicators of Serbia's external position

	2002	2003	2004	2005	2006	2007	2008	2009	2010	Q1 2011	Q2 2011	Q3 2011
EXTERNAL LIQUIDITY INDICATORS (in %)												
Forex reserves/imports of goods and services (in months)	4.1	4.7	3.9	6.1	9.0	7.2	5.2	9.4	8.1	7.7	7.5	8.4
Forex reserves/short-term debt	360.7	535.6	702.2	519.2	941.7	917.5	380.8	528.8	546.4	889.1	1,031.6	1,323.9
Forex reserves /GDP	13.6	16.4	16.3	24.2	38.7	33.8	25.0	36.7	34.5	33.6	32.6	36.0
Debt repayment/GDP	1.4	2.0	3.9	4.7	7.0	10.1	10.6	11.5	11.8	14.4	11.1	12.1
Debt repayment/exports of goods and services	7.0	9.0	16.4	17.7	23.5	33.2	34.0	39.1	34.0	39.7	31.1	34.3
EXTERNAL SOLVENCY INDICATORS (in %)												
External debt/GDP	58.7	55.9	49.8	60.1	60.9	60.2	64.6	77.9	82.1	76.7	74.4	75.6
Short-term external debt/GDP	3.8	3.1	2.3	4.7	4.1	3.7	6.6	6.9	6.3	3.8	3.2	2.7
External debt/exports of goods and services	300.9	251.6	211.5	228.9	204.1	197.3	207.6	265.3	236.2	213.0	206.1	210.4
FINANCIAL RISK EXPOSURE INDICATORS (in %)												
Forex reserves/M1	143.3	195.1	220.1	290.3	356.1	306.7	300.4	393.4	416.6	446.7	431.1	448.1
Forex reserves/reserve money	131.9	167.8	165.5	169.8	179.5	173.8	140.7	190.5	196.4	202.5	209.4	228.1
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	59.3	63.9	73.7	73.6	81.2	85.8	86.8	73.6	86.4	80.0	86.4	85.2
MEMORANDUM: (in EUR million)												
GDP (in EUR million)	16,028	17,306	19,026	20,306	23,305	28,468	32,668	28,883	28,984	7,136	8,078	8,472 ¹⁾
External debt	9,402	9,678	9,466	12,196	14,182	17,139	21,088	22,487	23,786	22,672	22,734	23,860
External debt servicing	218	348	736	945	1,635	2,885	3,453	3,314	3,403	1,026	898	1,025
Central bank foreign exchange reserves	2,186	2,836	3,104	4,921	9,020	9,634	8,162	10,602	10,002	9,919	9,967	11,358
Short-term external debt	606	529	442	948	958	1,050	2,143	2,005	1,830	1,116	966	858
Current account balance	-671	-1,347	-2,620	-1,778	-2,356	-5,053	-7,054	-2,084	-2,082	-761	-621	-676
			Nov. 2004	July 2005	Feb. 2006	June 2007	March 2008	Dec. 2009		March 2011	June 2011	
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	Standard & Poor's and Fitch: BB-/stable	Standard & Poor's: BB /stable; Fitch: BB-/stable	Standard & Poor's: BB /stable; Fitch: 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.

¹⁾ NBS estimate.

Notes:

- Data are subject to corrections in line with the official data sources.
- 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.
- Trade with Montenegro is registered within relevant transactions as of 2003.
- Foreign debt repayment does not include early debt repayment.
- In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.
- 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.
- 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).
- Balance of Payments for September 2011 - preliminary data.

Table B
Key macroeconomic indicators

	2002	2003	2004	2005	2006	2007	2008	2009	2010	Q1 2011	Q2 2011	Q3 2011
Real GDP growth (in %)	4.3	2.5	9.3	5.4	3.6	5.4	3.8	-3.5	1.0	3.7	2.4	0.7
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	10.3	14.1	12.7	9.3
Core inflation (in %, relative to the same month a year earlier) ²⁾	4.4	6.1	11.0	14.5	5.9	7.9	10.8	3.6	8.6	13.2	13.6	9.9
NBS foreign exchange reserves (in EUR million)	2,186	2,836	3,104	4,921	9,020	9,634	8,162	10,602	10,002	9,919	9,967	11,358
Exports (in EUR million) ³⁾⁷⁾	3,125	3,847	4,475	5,330	6,949	8,686	10,157	8,478	10,070	2,586	2,883	2,985
- growth rate in % compared to a year earlier	16.0	23.1	16.3	19.1	30.4	25.0	16.9	-16.5	18.8	28.7	15.5	11.5
Imports (in EUR million) ³⁾⁷⁾	-6,387	-7,206	-9,543	-9,613	-11,971	-16,016	-18,843	-13,577	-14,838	-3,873	-4,100	-4,237
- growth rate in % compared to a year earlier	27.2	12.8	32.4	0.7	24.5	33.8	17.7	-28.0	9.3	20.5	12.0	8.1
Current account balance ⁴⁾⁷⁾ (in EUR million)	-671	-1,347	-2,620	-1,778	-2,356	-5,053	-7,054	-2,084	-2,082	-761	-621	-676
as % of GDP	-4.2	-7.8	-13.8	-8.8	-10.1	-17.7	-21.6	-7.2	-7.2	-10.7	-7.7	-8.0
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	/	22.2	/
Wages (average for the period, in EUR)	152.1	176.9	194.6	210.4	259.5	347.6	358.4	337.9	330.1	338.3	380.9	381.4
RS budget deficit/surplus (in % of GDP) ⁶⁾	-4.3	-2.6	-0.3	0.3	-1.9	-1.7	-1.7	-3.3	-3.6	-3.7	-4.9	-3.5
Consolidated fiscal result (in % of GDP)	-1.8	-2.4	0.8	0.9	-1.9	-2.0	-2.5	-4.6	-4.6	-3.1	-3.8	-3.8
RS public debt (external + internal, in % of GDP) ⁶⁾	71.9	63.7	50.9	50.6	40.1	31.8	26.9	34.1	41.9	43.0	43.5	46.7
RSD/USD exchange rate (average, in the period)	64.70	57.56	58.44	66.90	67.01	58.39	55.76	67.47	77.91	75.92	69.41	72.15
RSD/USD exchange rate (end of period)	58.98	54.64	57.94	72.22	59.98	53.73	62.90	66.73	79.28	73.22	70.64	74.68
RSD/EUR exchange rate (average, in the period)	60.66	65.13	72.70	83.00	84.10	79.96	81.44	93.95	103.04	103.95	99.80	101.95
RSD/EUR exchange rate (end of period)	61.52	68.31	78.89	85.50	79.00	79.24	88.60	95.89	105.50	103.60	102.46	101.17
<i>Memorandum</i>												
GDP (in EUR million)	16,028	17,306	19,026	20,306	23,305	28,468	32,668	28,883	28,984	7,136	8,078	8,472 ¹⁾

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⁾ Sources: MoF for public debt and NBS for estimated GDP.

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

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

Table C
IMF's projection for key macroeconomic indicators (October 2011)
(IMF Country Report No. 11/311, October 2011)

	2007	2008	2009	2010	2011 (Projection)	2012 (Projection)
Output, prices and labor market (change in percent)						
Real GDP growth	5.4	3.8	-3.5	1.0	2.0	3.0
Real domestic demand (absorption)	10.2	4.9	-9.0	-2.2	1.4	1.4
Consumer prices (average)	6.5	12.4	8.1	6.2	11.3	4.3
Consumer prices (end of period)	11.0	8.6	6.6	10.3	7.9	3.5
Nominal gross wage	22.4	17.8	-3.3	7.5	10.1	7.0
Real gross wage	14.5	4.8	-10.5	1.2	-1.0	2.5
General government finance (in percent of GDP)						
Revenue	44.0	42.8	42.3	41.0	39.2	39.3
Expenditure	45.9	45.5	46.7	45.6	43.7	43.1
Fiscal balance	-1.9	-2.7	-4.5	-4.6	-4.6	-3.9
Public debt	35.6	34.2	38.2	44.9	44.1	44.5
Monetary sector (end of period 12-month change, in percent)						
Money (M1)	25.3	-3.8	8.7	-2.2	9.3	13.6
M3 ¹⁾	44.5	9.6	21.8	13.9	20.7	11.1
Domestic credit to non-government	36.9	35.0	15.9	29.0	10.8	14.3
Balance of payments (in percent of GDP)						
Current account balance	-15.9	-21.4	-7.1	-7.2	-7.6	-8.8
Export of goods	22.4	22.7	20.7	25.7	26.6	28.5
Import of goods	45.7	48.7	38.5	42.2	42.0	43.2
Trade of goods balance	-23.1	-26.0	-17.7	-16.5	-15.4	-14.7
Capital and account balance	18.4	16.7	11.1	2.8	7.6	7.2
External debt	61.8	66.7	79.4	82.2	75.3	70.1
of which: Private external debt	39.5	47.2	54.0	53.4	49.0	48.0
Gross official reserves (in billions of euro)	9.5	8.2	10.6	9.8	10.1	9.4
REER (annual average change, in percent; + indicates appreciation)						
	9.6	6.5	-6.8	-7.8	10.5	1.0

¹⁾ Excluding frozen foreign currency deposits.

Appendix: National Bank of Serbia's Letter to the Government of the Republic of Serbia on Reasons Why Inflation Departed from the Target

Belgrade, 12 October 2011

GOVERNMENT OF THE REPUBLIC OF SERBIA

Mirko Cvetković, Prime Minister

Dear Mr Cvetković,

As inflation has continued to trend for six consecutive months above the upper bound of the target tolerance band, we address you in accordance with the *Agreement between the National Bank of Serbia and the Government of the Republic of Serbia on Inflation Targeting* (Section 6, paragraph 4) in order to explain why inflation has moved away from the upper bound of the target, the policy action that we have taken to deal with it and the period within which we expect inflation to return within the target tolerance band.

Year-on-year inflation picked up in the second half of 2010 and early 2011, from 4.2% in June 2010 to 14.7% in April 2011. Rising food and administered prices pushed up year-on-year inflation to its April peak, after which it trended downward, as announced in our letter of 12 April 2011. In September, inflation came at 9.3%, still exceeding the upper bound of the target tolerance band.

In the last six months inflation declined owing to taken monetary policy measures, the weakening of cost-push pressures on food prices and low aggregate demand.

Monetary policy measures over the last year have been taken cautiously in order to bring inflation back to the target in the medium term without major volatility. They prevented a rise in inflation expectations and, consequently, the pass-through of the inflationary shock from food prices to other prices. Results are also visible in declining monthly inflation rates over the last six months, as well as in mild deflation in the third quarter. These results and the lag effect of monetary policy measures allowed for gradual lowering of the key policy rate since June 2011.

Low aggregate demand will continue to be the disinflationary factor in the coming period, as confirmed by current and expected developments at home and abroad. We expect food prices to be stable and administered price growth slower. Furthermore, we estimate that the disinflation process will also be aided by the nascent decline in inflation expectations and the favourable impact of the precautionary stand-by arrangement concluded with the International Monetary Fund.

The Executive Board of the National Bank of Serbia expects that inflation will continue to decline and that it will enter the target tolerance band in the first half of 2012, as announced in the letter we sent to you on 12 April 2011.

We assess that low and stable inflation in the medium run would also be aided by continued implementation of initiated structural measures, which should ensure higher stability of agricultural and food prices, as well as the process of restructuring of public enterprises and balanced growth in administered prices within the previously agreed limits.

Yours sincerely,

Governor

Dejan Šoškić

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Executive Board* Meetings and Changes in the Key Policy Rate

2011

Date	Key policy rate (p.a., in %)	Change (in basis points)
17 January	12.00	+50
10 February	12.00	0
10 March	12.25	+25
7 April	12.50	+25
12 May	12.50	0
9 June	12.00	-50
7 July	11.75	-25
11 August	11.75	0
8 September	11.25	-50
6 October	10.75	-50
10 November	10.00	-75
8 December		

2012

Date	Key policy rate (p.a., in %)	Change (in basis points)
19 January		
9 February		
8 March		
12 April		
10 May		
7 June		
12 July		
9 August		
6 September		
18 October		
8 November		
6 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 11 August 2011

After reviewing current economic developments and the August inflation projection at its meeting today, the Executive Board of the National Bank of Serbia voted to keep the key policy rate unchanged at 11.75 percent.

In line with the Executive Board's earlier judgements, inflation is on a declining path. The main factors behind its decline are the drop in food prices, occasioned by a good agricultural season, and low aggregate demand. The fall in y-o-y inflation rates over the coming period should lead to a drop in inflation expectations, which will provide additional impetus to the disinflation process.

However, given potential implications regarding risks in some developed countries and currency zones, as well as possible fiscal risks at home, the Executive Board decided to keep the key policy rate on hold for the time being. The NBS will continue to monitor developments on the international plane and, if necessary, take appropriate measures in order to mitigate possible spillovers of the global turmoil to the domestic market.

At today's meeting, the Executive Board adopted the Inflation Report – August 2011. The Report will be published and publicly presented on 17 August, at 10.30 a.m.

The next rate-setting meeting will be held on 8 September 2011.

Press release from Executive Board meeting held on 8 September 2011

After reviewing current economic developments and estimates for the coming period, the NBS Executive Board voted to lower the key policy rate by half a percentage point to 11.25 percent.

Downward trends in inflation and inflationary pressures persist. The Executive Board assesses that low aggregate demand will continue to be a strong disinflationary factor in the coming period, which is also confirmed by the latest information on current and expected developments in the country and in the region. The Executive Board also expects stabilisation of food prices and slower growth in regulated prices.

The deepening of global economic problems remains a possibility. Concluding a precautionary arrangement with the IMF will help ease possible implications regarding the risks in some advanced economies and currency zones. Implementation of fiscal policy in line with agreed fiscal responsibility rules is of key importance for safeguarding macroeconomic stability and reducing the country risk.

The decision on further relaxation of monetary policy was adopted to ensure that inflation returns to the target, without major volatility. The Executive Board expects that inflation will continue to decline until the end of the year and that it will enter the target tolerance band in the first half of the next year. Future path of the key policy rate will depend on the materialisation of risks, primarily in the international environment, and those relating to fiscal policy at home.

The next rate-setting meeting will be held on 6 October 2011.

Press release from Executive Board meeting held on 6 October 2011

After reviewing current economic developments and estimates for the period ahead, the NBS Executive Board decided in its meeting today to lower the key policy rate by half a percentage point to 10.75 percent.

Inflation is on a downward path. The Executive Board expects that the September inflation will be in single digits and that it will continue trending closer to the target. Food prices have stabilised and the growth in regulated prices has slackened. As indicated by current and expected developments at home and abroad, low aggregate demand will continue to be the key disinflationary factor. The disinflation process will also be aided by the nascent decline in inflation expectations.

The precautionary stand-by arrangement concluded with the IMF supports the Republic of Serbia's economic programme aimed at maintaining macroeconomic and financial stability. The key to the implementation of the programme in an uncertain global environment is the pursuance of fiscal policy in line with fiscal responsibility rules.

The stand-by arrangement will help improve the investment climate and additionally ensure the Serbian economy against adverse external effects of the crisis.

The Executive Board expects that inflation will continue to decline and that it will enter the target tolerance band in the first half of the next year. The future path of the key policy rate will depend on the achievement of projected inflation, and on the materialisation of risks, primarily those stemming from the international environment and fiscal policy at home.

The next rate-setting meeting will be held on 10 November 2011.

Press release from Executive Board meeting held on 10 November 2011

After reviewing current economic developments and the November inflation projection, the NBS Executive Board voted to lower the key policy rate by 0.75 percentage points to 10 percent.

Inflation continued down, in accordance with the NBS projection from the August Inflation Report. It is expected to decline further in the coming period. The key disinflationary factors will be weaker cost-push pressure on food prices, low aggregate demand and slower growth in administered prices. The process of disinflation will also be aided by the continued drop in inflation expectations.

Due to mounting uncertainty over public debt crisis in some eurozone members, the pace of the global economic growth will be much slower than expected until recently. Most countries are having their growth forecasts for this and the next year revised downwards. The implications for Serbia are lower than expected export demand and economic growth, as well as stronger disinflationary pressures.

In an environment of heightened global uncertainty, support to the country's macroeconomic and financial stability is provided by the precautionary stand-by arrangement concluded with the IMF, as well as by the just-announced confirmation of Serbia's stable credit rating.

This time again, the Executive Board reaffirms its belief that y-o-y inflation will continue to fall and that it will return within the target tolerance band in the first quarter of 2012. The future path of the key policy rate will depend on the inflation projection and the materialisation of risks, notably those associated with the international environment and fiscal policy at home.

The next rate-setting meeting is scheduled to take place on 8 December.

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