National Bank of Serbia

2013
November

INFLATION REPORT

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

Introductory note

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

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

The *Inflation Report* aims to cover information on the current and expected inflation movements and to provide 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 National Bank of Serbia.

The November *Inflation Report* was considered and adopted by the NBS Executive Board in its meeting of 7 November 2013.

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

ABBREVIATIONS

bln – billion
bp – basis point
CEFTA – Central European Free Trade Agreement
CPI – Consumer Price Index
ECB – European Central Bank
EIB – European Investment Bank
EMBI – Emerging Markets Bond Index
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
NBS – National Bank of Serbia
NPLs – non-performing loans
OFI – other financial organisations
OPEC – Organisation of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
QE – quantitative easing
q-o-q – quarter-on-quarter
s-a – seasonally-adjusted
SDR – Special Drawing Rights
SORS – Statistical Office of the Republic of Serbia
WTO – World Trade Organisation
y-o-y – year-on-year

Other generally accepted abbreviations are not cited

Contents

I. Overview

Year-on-year inflation has returned within the target tolerance band (4±1.5%) in September.

Inflationary pressures weakened further in the third quarter and year-on-year inflation returned within the target tolerance band, confirming the projection and expectations reiterated by the National Bank of Serbia over the last 18 months. The key contribution to inflation's return within the target came from monetary policy measures, falling prices of primary agricultural commodities, low aggregate demand and relative stability of the exchange rate of the dinar.

The fall in primary agricultural commodity prices has triggered a decline in food prices in 2013.

Good agricultural performance both domestically and worldwide and the consequently decreased food production costs have brought about a fall in unprocessed food prices and only a minor rise in processed food prices since the beginning of the year. The disinflationary effect of food prices should be sustained at least until the next agricultural season.

One-year ahead inflation expectations of the financial sector have also returned within the target tolerance band.

The weakening of inflationary pressures was aided by the significant decline in inflation expectations in nearly all of the sectors surveyed. One-year ahead inflation expectations of the financial sector returned within the target tolerance band in October and edged further down in November.

Prospects for the euro area economy have improved – its fall in 2013 is likely to be smaller and its growth in 2014 stronger than expected before.

The euro area emerged from recession in the second quarter. Its recovery is expected to gain ground in the coming period, generating positive effects on economic movements in Serbia and the rest of the region. The global economic environment in Q3 remained under the dominant sway of developments in the United States, i.e. anticipation of the Fed's decision on the monetary stimulus tapering and the budget and debt ceiling crises.

In the third quarter, the exchange rate of the dinar was again under the dominant influence of global factors.

Uncertainty in the international financial markets persisted until the Fed's September meeting which postponed the decision on the start of reduction of the quantitative easing programme. Coupled with positive foreign trade trends, this led to the weakening of depreciation pressures in the domestic market from September onwards and paved the way for appreciation pressures in October.

Potential negative effects from the international environment could be offset significantly by consistent implementation of fiscal consolidation.

The Government unveiled a new set of economic policy measures in October to help public finance stabilise and the economy recover. The most important short-term measures include raising the special VAT rate, introducing solidarity tax on above-average public sector wages, and economising on goods and services. The proposed extension of fixed indexation of public sector wages and pensions and the cut in subsidies should support fiscal adjustment in the medium term.

Foreign investors' interest in government securities has increased since October.

Non-residents' participation in the primary market of government securities increased after the announcement of fiscal consolidation measures, which induced a mild strengthening of the dinar against the euro. To ease excessive daily appreciation of the dinar, the National Bank of Serbia intervened in the IFEM and bought EUR 165.0 mln.

After a temporary halt in the third quarter, the process of monetary policy easing continued in October.

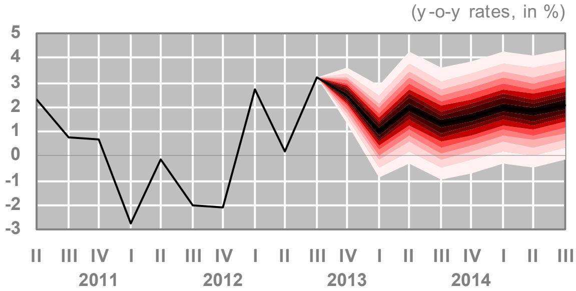
The Executive Board of the National Bank of Serbia is taking cautious steps in the current cycle of monetary easing – after downward revisions in May and June, the key policy rate was kept on hold until October. Once the risks stemming from international environment and fiscal policy at home had abated, it was lowered by 50 bp in October and again in November by the same amount down to the level of 10.0%.

External imbalance continues down.

Owing to exceptionally positive foreign trade trends, higher inflow of remittances and lower interest payments, in the first nine months of 2013 the current account deficit was cut by around 58% from the same period a year earlier. Net exports have been growing at a brisk pace, spurred by continuing expansion of the automobile industry, substitution of petroleum product imports, but also by fiscal consolidation measures. In 2013 as a whole, we expect the current account deficit to reach 4–5% of GDP, less than anticipated in the August *Report*.

The estimated GDP growth of around 2.0% this year is above average for Southeast Europe.

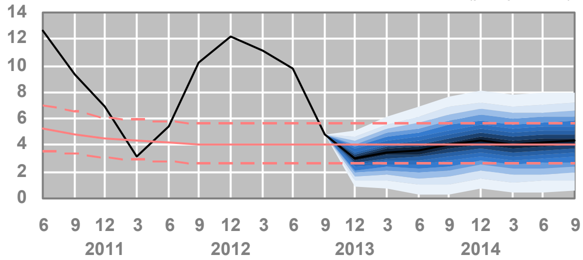
GDP growth projection
(y-o-y rates, in %)



Economic activity stepped up during the third quarter. On the production side, growth was led chiefly by the rising industrial and agricultural output, and on the expenditure side, by net exports. These factors will determine GDP growth in the year as a whole, which is estimated at around 2.0%. The nascent recovery of the euro area and the start of negotiations on EU membership are expected to provide a key boost to investment growth and further rise in net exports in 2014. However, due to fiscal consolidation, the contributions of government and household consumption will remain negative. As additional fiscal consolidation measures will have a negative short-term effect on economic activity, the GDP growth projection for 2014 has been trimmed down to around 1.5%.

Year-on-year inflation will continue to move within the target tolerance band in 2014.

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



The Executive Board of the National Bank of Serbia will consider further monetary easing in the coming period.

Year-on-year inflation should reach its trough in October, once we exclude from calculation the high monthly inflation rate (2.8%) recorded in October 2012 amid an increase in the general VAT rate and excise duties. In late 2013 and throughout 2014, year-on-year inflation is expected to move within the target tolerance band (4±1.5%).

Given the subsiding of inflationary pressures and assuming fiscal consolidation is implemented as planned, the Executive Board will consider further monetary policy easing in the coming period. However, as unexpected changes in the impact of some factors on the inflation projection remain possible, the above statement with regard to the character of monetary policy in the coming period is in no way binding on the NBS.

II. Monetary policy since the August *Report*

After a temporary halt in Q3, the process of monetary policy easing continued in October.

Inflationary pressures receded further in the course of Q3, reflecting not only past monetary policy measures, but also the weakening of the cost-push pressure in the production of food on account of better agricultural performance both domestically and worldwide. In line with the earlier announcements of the NBS Executive Board, y-o-y inflation returned within the target tolerance band (4±1.5%), measuring 4.9% in September.

The Executive Board is taking cautious steps in the current cycle of monetary easing. After cutting the key policy rate in May and June, the Executive Board **kept the rate on hold (11.0%) until October**, mindful of uncertainties in the international financial markets over the Fed's future policy move and of the need for additional fiscal consolidation measures and structural reforms.

To be more precise, the Executive Board was guided by the fact that the Fed's mere hint at QE tapering caused an increase in investor risk aversion and gave rise to depreciation pressures in May and June in nearly all countries of the region, Serbia included. When the Fed officials echoed that the central bank is likely to keep easy-money policies in place until the economy is back on its feet, volatility in the global financial markets eased to a degree. However, concerns over the longevity of the QE programme persisted until September when the decision on the start of QE tapering was postponed. As a result, depreciation pressures in the domestic market receded from mid-September onwards, which, together with the effects of restrictive monetary policy in the prior period and a substantial reduction of external imbalance, helped stabilise the exchange rate of the dinar.

In the Executive Board's view, potential negative effects from external environment could be offset significantly by consistent implementation of fiscal consolidation measures and structural reforms. In this context, the Government unveiled a new set of measures in October. The most important short-term measures include raising the special VAT rate from 8% to 10% (and for some products to 20%), introducing solidarity tax on public sector wages over 60,000 dinars, and economising on goods and services. Medium-term measures include extension of fixed indexation of public sector wages and pensions over to 2015 and 2016 (limited to 0.5% in April and October each, irrespective of inflation and economic growth), as well as public enterprise restructuring and a gradual decrease in subsidies. Raising the retirement age for women from 60 to 63 years until 2020 was announced as a long-term measure.

Fiscal adjustment, reinforced by a systemic public sector reform, is needed to ensure fiscal sustainability and curb public debt growth. This would have a positive effect on investor perception of Serbia and would contribute to the narrowing of internal and external imbalances, lowering of inflation and sustainable economic growth.

In its **October and November meetings**, the Executive Board decided to **cut the key policy rate by half a percentage point, to 10.0%**. In making this decision, the Board took into account the weakening of inflationary pressures and the reduced balance of risks related to fiscal movements in the wake of announced fiscal adjustment measures. It is expected that these measures will weigh down on demand and that the negative output gap will continue to generate strong disinflationary pressures, despite gradual economic recovery. The projection of GDP growth for 2014 has been revised down because of the anticipated negative effects of fiscal consolidation on total final consumption.

In such circumstances, the VAT rate increase will generate minor one-off direct and indirect effects on inflation. Besides, uncertainties in the international financial markets are expected to lessen.

III. Inflation developments

Inflationary pressures continued to subside in Q3. In September, y-o-y inflation returned within the target tolerance band, confirming the projection and expectations communicated by the NBS over the past 18 months. The key contribution was provided by monetary policy measures, falling prices of primary agricultural commodities, low aggregate demand and relative stability of the dinar exchange rate. Inflationary pressures weakened also on account of falling inflation expectations of almost all sectors.

Following the October trough, y-o-y inflation will rise moderately by the year-end, but will remain within the target band.

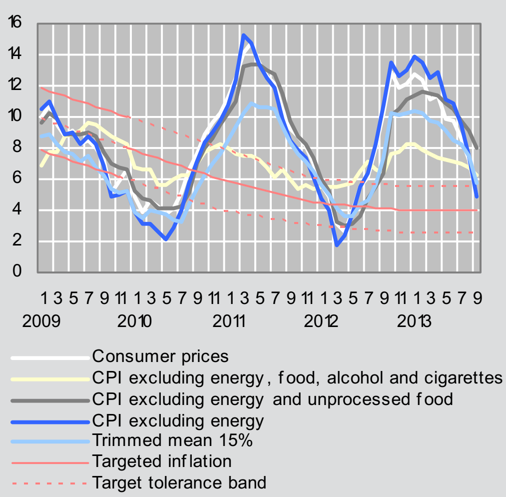
Inflation developments in Q3

Consumer prices declined in Q3 on the back of falling prices of food, notably unprocessed, triggered by the seasonal drop in fruit and vegetable prices.

In Q3, y-o-y inflation moved within the bounds of the short-term inflation projection published in the August *Inflation Report* and reached 4.9% in September. This implied inflation's return within the target tolerance band, confirming the projection and expectations communicated by the NBS over the past 18 months. The key contribution was provided by monetary policy measures, falling prices of primary agricultural commodities, low aggregate demand and relative stability of the dinar exchange rate.

The weakening of inflationary pressures, present from late 2012, continued into Q3. Since early 2013, the average monthly inflation rate equalled 0.3%, or 2.5% in

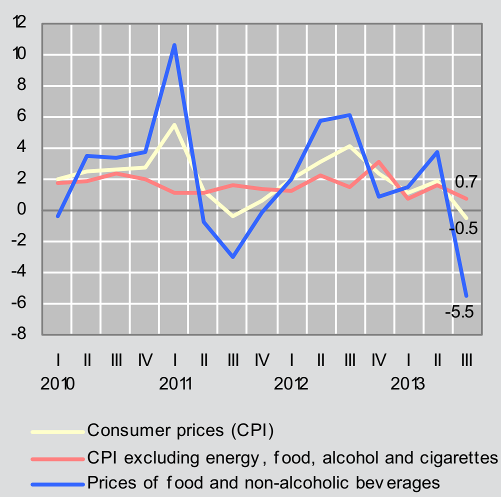
Chart III.0.1 **Price movements**
(y-o-y rates, in %)



Sources: SORS and NBS calculation.

Consistent with our expectations, y-o-y inflation returned within the target tolerance band in September.

Chart III.0.2 **Price movements**
(quarterly rates, in %)



Sources: SORS and NBS calculation.

Headline inflation declined owing to a drop in food prices and a slowdown in core inflation.

the first nine months. Around 1.9 pp of headline inflation is due to administered price growth. A good agricultural season and consequently lower food production costs, brought about a decline in unprocessed food prices and a negligible increase in processed food prices.

Consumer prices shed 0.5% in Q3. Broken down by month, inflation declined in July (0.9%) on account of the seasonal drop in fruit and vegetable prices, but increased in August (0.4%) as electricity prices went up. It stayed flat in September.

Prices of food and non-alcoholic beverages lost 5.5% in Q3. A 13.4% fall was recorded for unprocessed food which contributed 1.9 pp to a decline in headline inflation. Within unprocessed food, fruit and vegetable prices dropped by 25.6%, while prices of fresh meat were up 8.9%. As cost-push pressures in food production weakened, processed food prices went down 0.3%, adding negative 0.1 pp to headline inflation. The major negative contribution within this category came from falling prices of bread and cereal products prompted by lower wheat prices.

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

	XII 2012 / XII 2011	III 2013 / III 2012	VI 2013 / VI 2012	IX 2013 / IX 2012
Consumer prices	12.2	11.2	9.8	4.9
Domestic industrial producer prices	6.4	5.4	4.3	1.6
Agricultural producer prices	35.4	17.3	5.2	17.5*
Prices of elements and materials incorporated in construction	5.1	3.3	3.1	2.5

* August-on-August.
Sources: SORS and NBS calculation.

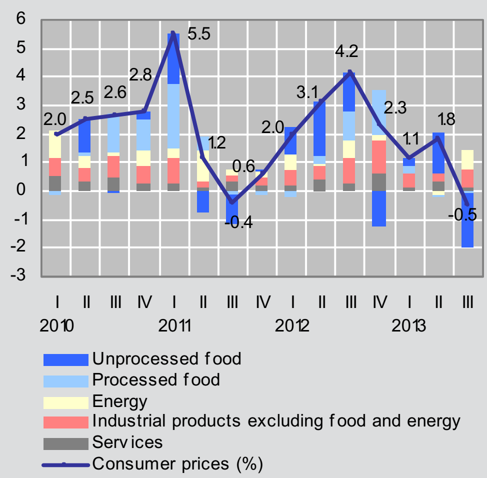
Industrial product prices excluding food and energy rose in Q3 (2.0%) to a higher extent than in the previous quarter, owing chiefly to cigarette price hikes in July and August (0.5 pp to headline inflation). The indirect effect on inflation of dinar's depreciation from the previous quarter and higher electricity prices was lower than expected because of low aggregate demand.

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

	2012		2013		
	III	IV	I	II	III
Consumer prices (CPI)	4.2	2.3	1.1	1.8	-0.5
Unprocessed food	9.1	-7.8	2.2	10.9	-13.4
Processed food	4.2	6.3	1.1	-0.4	-0.3
Industrial products excluding food and energy	3.6	4.8	1.7	0.9	2.0
Energy	3.5	1.1	-0.2	-0.9	5.1
Services	1.4	3.3	0.6	1.8	0.7
Core inflation indicators					
CPI excluding energy	4.3	2.6	1.4	2.3	-1.4
CPI excluding energy and unprocessed food	3.3	5.0	1.2	0.7	1.0
CPI excluding energy, food, alcohol and cigarettes	1.5	3.1	0.7	1.7	0.7
Administered prices	2.9	5.2	2.9	0.7	5.6

Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

Inflation declined in Q3 chiefly on the back of the seasonal drop in fruit and vegetable prices.

Prices within the group of **energy** rose 5.1%. In addition to a 10.8% rise in household electricity prices (0.5 pp to headline inflation), an impetus also came from petroleum products (0.1 pp). The escalation of the crisis in the Near East prompted a rise in global oil prices and a 2.7% increase in petroleum product prices.

Prices of **services** increased less than in Q2 (0.7%). The main driver were higher utilities prices (household water).

As inflationary pressures subsided, **core inflation** (measured by CPI excluding prices of energy, food, alcohol and cigarettes) was lower in Q3 (0.7%) than in the previous quarter (1.7%). In y-o-y terms, it continued to slow to 6.3% in September.

Since early 2013, **administered prices** rose the most in Q3 (5.6%), mainly in response to rising household electricity and cigarette prices. Of other administered prices, a rise was recorded only for natural gas, utilities and transportation services in some towns, and medicaments.

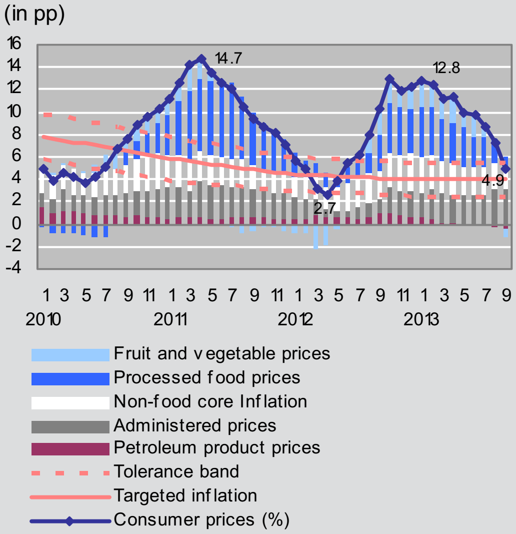
Industrial producer prices for the domestic market rose by 1.1% in Q3, notably in response to higher electricity prices (contribution of 1.8 pp). The sharpest drop was recorded for the exploitation of metal ores. The downward tendency continued in y-o-y terms – 1.6% in September.

Agricultural producer prices[1] fell by 13.6% in August relative to Q2, or 17.5% y-o-y. A drop of more than 25% was recorded in the categories of cereals and industrial plants. Fruit and vegetable prices experienced a steep decline. Only live stock prices went up, pushing up retail prices of fresh meat.

Prices of elements and materials incorporated in construction gained 2.6% in Q3, though their y-o-y growth continued to slow, to 2.5% in September.

Unlike in the previous three quarters, **import prices expressed in dinars**[2] edged up 2.1%[3] in Q3. Rising global oil and import consumer goods prices pushed up imported inflation, also on account of dinar's depreciation against the euro. In contrast, Q3 saw a reduction in world food prices and import prices of intermediate goods, slowing the rise in imported inflation. In y-o-y terms, the decline in import prices accelerated in Q3 and reached 3.2% in September.

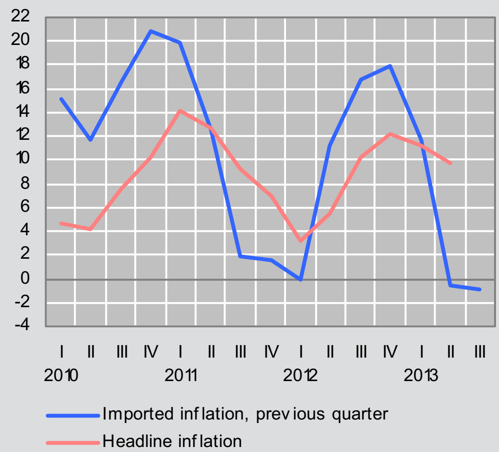
Chart III.0.4 **Contribution to y-o-y consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

A decline in food prices contributed to the drop in y-o-y inflation and its return within the target tolerance band in September.

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



Sources: NBS and Eurostat.

Import prices declined further y-o-y in Q3 and are likely to continue producing disinflationary pressures in the coming period.

[1] Producer prices in agricultural and fishing sectors.

[2] As an indicator of import prices, we used the weighted average indices of global oil and food prices, export and consumer prices of Germany as our most important foreign trade partner.

[3] The ratio of averages for two consecutive quarters.

Short-term inflation projection

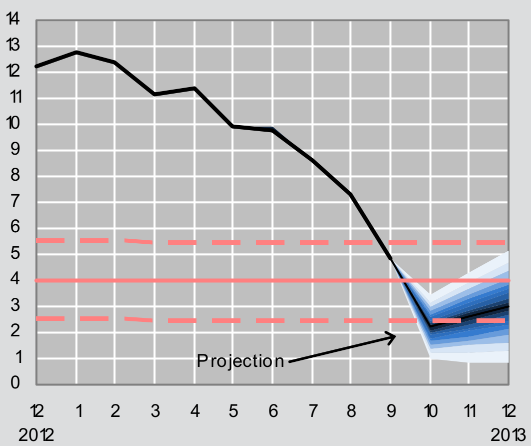
Y-o-y inflation will be lower in Q4, but will rise in quarterly terms, chiefly in response to administered price growth.

According to our estimates, y-o-y inflation will touch its trough in October and most probably fall below the lower bound of the target tolerance band. It is expected to increase moderately and move within the target band over the next two months.

In quarterly terms, the greatest positive contribution in Q4 is expected from prices of services and unprocessed food because of the seasonally expected increase in fruit and vegetable prices. In contrast, owing to exceptionally low cost-push pressures in food production, a negative contribution is expected from processed food.

Industrial product prices excluding food and energy are estimated to rise less in Q4 than in Q3. The indirect effects of the spillover of electricity price hikes and dinar's depreciation from Q2 to other prices have not materialised and are not likely to materialise in Q4 either owing to low domestic demand.

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



Source: NBS.

Following the October trough, y-o-y inflation will rise moderately until end-2013, but will remain within the target tolerance band.

Much lower growth is expected in the energy group compared to Q3. Heating prices are likely to go up because of the September increase in natural gas prices and the seasonal rise in solid fuel prices at the start of the heating season. In light of the subsiding tensions in the Near East and the plummeting global oil prices, no surges in petroleum product prices are anticipated.

It is estimated that the price growth in services will be led by the seasonal increase in travel arrangement and transportation prices, as well as higher student accommodation rental prices. As services become more expensive, the growth in core inflation is expected to outstrip the Q3 levels. Y-o-y inflation will, however, continue down and return within the target tolerance band after six quarters.

After additional, medium-term fiscal consolidation measures were presented, risks associated with domestic fiscal developments and their potential impact on the exchange rate subsided.

The greatest uncertainty surrounding the Q4 projection is associated with fruit and vegetable prices, and less with developments in the international environment and their potential effects on risk premium and the exchange rate. Moreover, the special VAT rate may be adjusted in December, instead in January as earlier assumed. Besides, the tightening of geopolitical tensions may have an adverse effect on global prices of primary commodities.

Inflation expectations

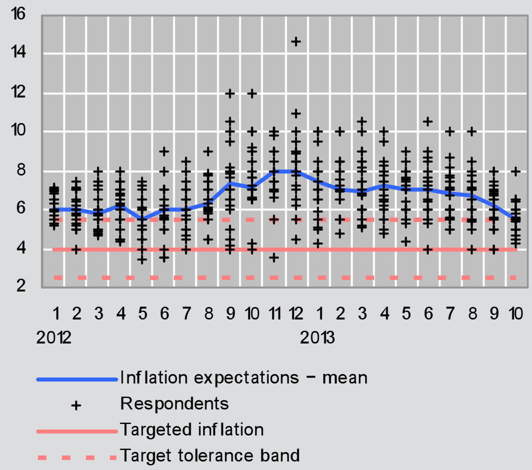
The decline in y-o-y inflation was accompanied by weakening inflation expectations of all sectors. Financial sector expectations entered the target tolerance band in October.

Under the results of the **Bloomberg** survey, after the August decline to 6.8%, one-year ahead inflation expectations of the **financial sector** accelerated down – to 6.3% in September and 5.5% in October. The October decline of 0.8 pp occurred despite the announced increase in the special VAT rate as part of new fiscal consolidation measures. As a result, financial sector expectations reached the upper bound of the target tolerance band, sliding down to 5.0% in November.

The **Ipsos** survey also recorded a sharp drop in inflation expectations of all sectors. One-year ahead **financial sector** expectations fell by 0.7 pp in both August and September, and by additional 1.1 pp to 5.0% in October, thus entering the target tolerance band. A decline in corporate inflation expectations was even more pronounced – 1.0 pp in both August and September, and 2.0 pp to 6.0% in October. Though still the highest, **household** expectations fell the most – 2.0 pp to 10.0% in August, staying flat in September, and declining further in October, by as much as 3.0 pp to 7.0%.

The dispersion of financial sector responses narrowed further according to both surveys. The disagreement among financial sector respondents remained smaller under the Bloomberg than the Ipsos survey. Following a July increase, the expectations dispersion among corporate respondents narrowed significantly in the following months, but remained pronounced. The highest

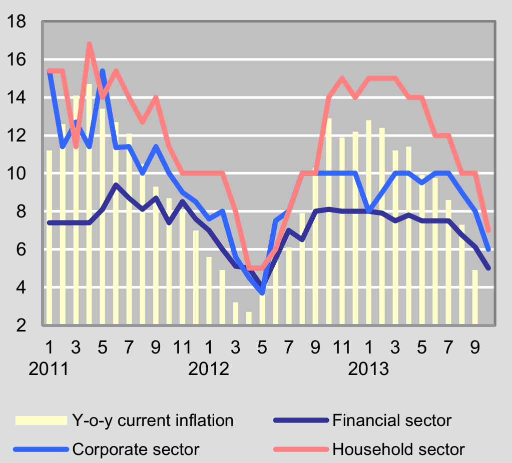
Chart III.0.8 **One-year ahead expected and targeted inflation – financial sector**
(y-o-y rates, in %)



Sources: Bloomberg and NBS.

The gap between respondents' inflation expectations continues to narrow.

Chart III.0.7 **Current inflation and one-year ahead inflation expectations – by sector**
(y-o-y rates, in %)

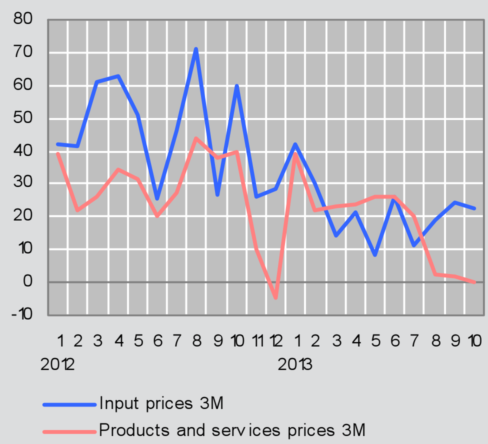


Sources: Gallup, Ipsos and NBS.

* Ipsos from November 2011 and Gallup in the earlier period.

A fall in current inflation was accompanied with subsiding inflation expectations of all sectors.

Chart III.0.9 **Expectations of enterprises regarding a change in prices of their inputs, products and services**
(net percentage, "+" = increase, "-" = decrease)



Sources: Ipsos and NBS.

Enterprises do not expect their product prices to rise.

disagreement is observed in the household sector, though it also contracted after the July increase.

The Ipsos survey shows that enterprises do not expect an increase in their product and services prices over the next three months. This is corroborated by the sharp fall in the net percentage of enterprises[4] expecting a rise in their product prices. A drop occurred even though the net percentage of enterprises expecting a rise in their input prices went up in Q3. However, the share of enterprises not expecting a rise in their input prices was dominant (around 75.0%).

[4] The difference between the percentage of enterprises expecting an increase and those expecting a reduction in the prices of their inputs, products and services. To increase representation, data are weighted by operating revenue.

Text box 1: Inflation targets by end-2016

At its October meeting, the NBS Executive Board set the medium-term y-o-y inflation targets for 2015 and 2016 at 4%±1.5 pp[1] (the y-o-y rate and the target tolerance band were kept the same as in 2013 and 2014).

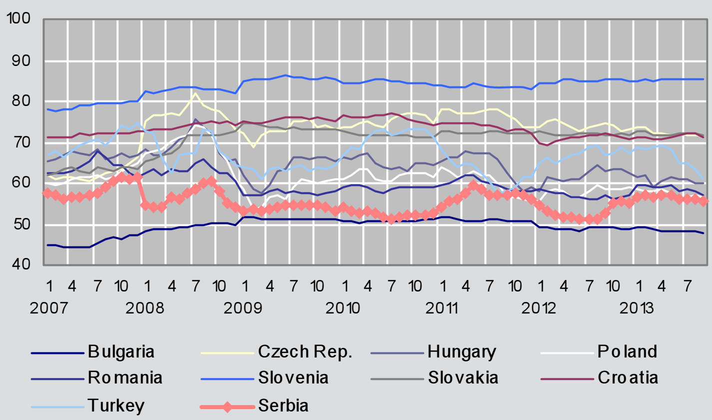
The decision to keep the inflation target unchanged until end-2016 was prompted by the fact that the convergence of Serbia's prices to EU levels has not been achieved, notably for administered prices. In September, price levels measured by CPI equalled 55.5% of the EU average, vs. 53.9% in late 2009, which implies a rather slow pace of conversion. The reason lies in high volatility of the real effective exchange rate of the dinar against the euro, which is why the process even reversed in some periods. Therefore, the speed of convergence in the coming years cannot be predicted with certainty.

Administered prices display a particularly low rate of convergence – 45.3%[2] compared to the EU average in September. The lowest convergence is noted for prices of waste removal, water supply, waste waters and medicaments (c. 38%). Prices of telephone services and heating show the highest level of convergence (over 50%). Annual administered price growth is expected at around 8–10% by end-2016, adding 2 pp to headline inflation (a 22.4% share in the consumer price basket).

The target tolerance band for end-2016 was kept unchanged. Over the past years, inflation has moved within a wider range than defined by the target tolerance band. Its volatility was driven mainly by food market instabilities, amplified by the absence of adequate systemic agrarian measures and the absence of a medium-term, clearly-defined framework for administered price adjustment.

Reducing inflation volatility remains the priority of monetary policy, but requires time. In this context, the government must define measures to stabilise and stimulate the business and investment environment in agriculture and food production and processing, and set a precise dynamics of administered price adjustment. This would contribute to permanent anchoring of inflation expectations to the level of targeted inflation.

Chart O.1.1 **Price levels by country**
(EU27 = 100)



Source: EUROSTAT.

[1] See Appendix 1, p. 51.

[2] EU-27 average.

IV. Inflation determinants

1. Money and capital market trends and bank lending

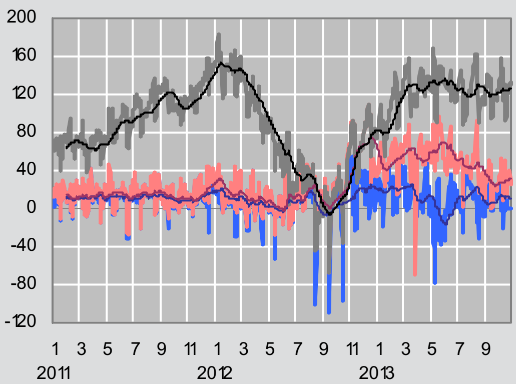
Interest rates

Interest rates in the interbank money and government securities markets rose slightly in Q3. Rates on corporate dinar loans also went up, while the price of dinar lending to households contracted.

The average repo rate[5] rose slightly in Q3. In late September, the rate stood at 9.4%, up by 0.6 pp on end-June. The rise was due to a higher amount of liquidity withdrawn at repo auctions, prompting a smaller deviation of the average repo rate from the key policy rate.

Average daily trading volumes in the interbank overnight money market amounted to RSD 1.2 bln in Q3, up by RSD 0.5 bln from Q2, while the number of non-trading days declined. However, despite moderate recovery, trading volumes remained significantly below the average quarterly volumes recorded in 2012. BEONIA has not changed a lot in Q3 – following a 0.3 pp drop to 8.7% in July, its average monthly value remained unchanged until the quarter-end.

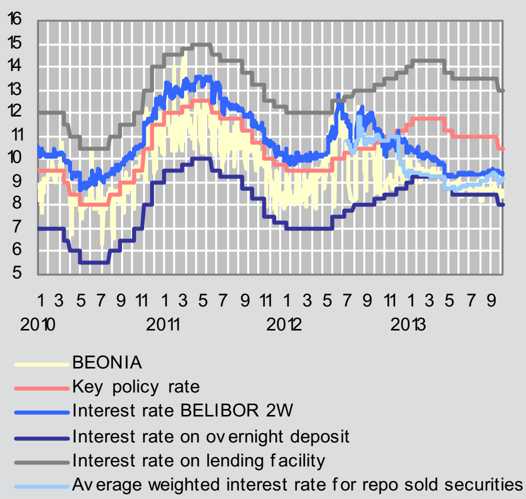
Chart IV.1.1. **Dinar liquidity**
(daily stock and moving averages, in RSD bln)



Source: NBS.

Q3 also saw a relatively high level of banking sector liquidity...

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

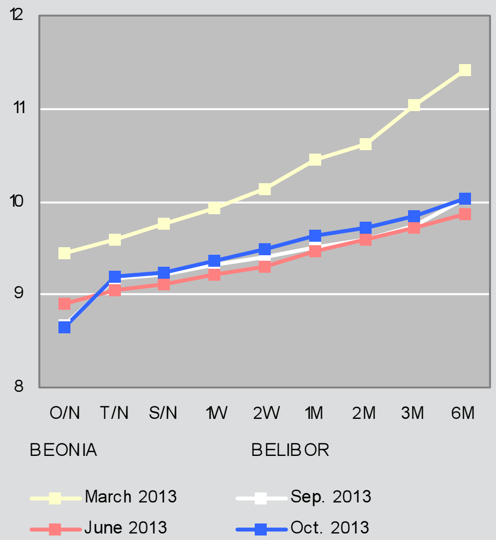


Sources: Thomson Reuters and NBS.

... and the rise in the weighted average repo rate did not fully reflect on the overnight money market rate.

[5] The rate achieved at repo auctions, weighted by the value of securities sold.

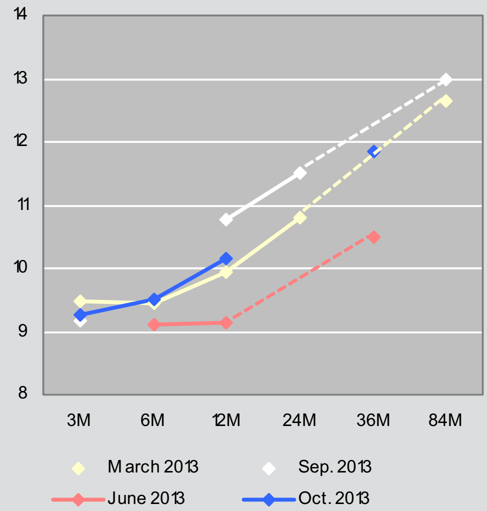
Chart IV.1.3 **Yield curve in the interbank money market**
(average values, p.a., in %)



Sources: Thomson Reuters and NBS.

Rates in the interbank money market rose moderately compared to Q2.

Chart IV.1.4 **Interest rates in the primary market of government securities**
(p.a., in %)



Source: Ministry of Finance.

Following the return of foreign investors to the securities market, longer-maturity rates declined in October.

BELIBOR rates of all maturities rose slightly in Q3 (up to 0.2 pp), but less than the weighted average repo rate. In September, average BELIBOR moved from 9.2% for the shortest to 10.0% for the longest maturity.

Mirroring cuts in the key policy rate, interbank money market rates went down in late October.

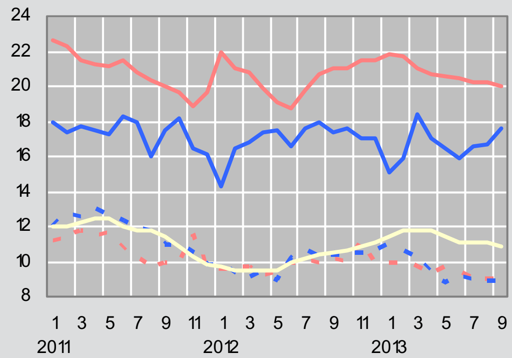
Rates increased also in the primary market of dinar government securities. The weighted average rate was up 1.3 pp to 10.8% in Q3. The rise was sharper for longer maturities, whilst only the three-month rate stayed flat relative to end-Q2. By late Q3, rates ranged between 9.2% for three-month and 13.0% for seven-year maturity. Such trends were shaped by reduced foreign investor interest in government securities, on the back of both global and domestic factors. Elevated uncertainties regarding Fed's tapering of the quantitative easing program was followed by deterioration in Serbia's fiscal position. In the course of Q3, securities worth nominal RSD 53.3 bln were sold (of total RSD 83.0 bln issued), while securities worth RSD 41.8 bln fell due. This pushed up the stock of debt under sold securities by RSD 11.5 bln to RSD 391.8 bln.

Q3 saw three auctions of euro-denominated securities, one each month. The nominal value of offered securities totalled EUR 150.0 mln, of which securities worth nominal EUR 114.4 mln were sold. The rates exceeded the Q2 levels (by 0.3 pp for two- and five-year maturities and 0.5 pp for three-year maturity) and moved from 4.5% for two-year and 5.25% for five-year maturity. Earlier issued securities worth EUR 102.2 mln fell due in Q3 and the stock of debt arrived at EUR 1.1 bln by late September.

Trading in the secondary market amounted to RSD 13.8 bln in Q3, down by RSD 50.2 bln from Q2. Excluding trading up to two business days from the primary settlement date, trading volumes contracted by RSD 23.5 bln to RSD 13.0 bln. However, rates of return remained broadly unchanged and moved in September from 9.0% for the remaining three-month maturity to 11.2% for 25-month maturity.

October experienced rising demand in the primary market of government securities – after an extended period, full performance was recorded at most auctions. Fed's deferred decision on tapering of the quantitative easing program, the announcement of new fiscal consolidation measures in Serbia, and higher returns recorded at earlier auctions, drove up foreign investor interest in government securities. Rates on shorter-maturity securities went slightly up, while a decline was recorded for most longer-term securities.

Chart IV.1.5 **Interest rates on new dinar loans and new corporate and household deposits***
(weighted average values, p.a., in %)

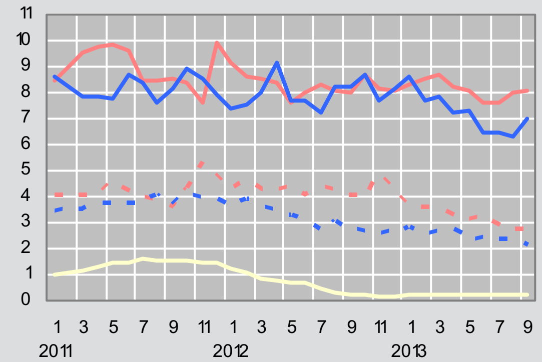


Source: NBS.

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

The rising cost of dinar corporate lending, together with a drop in deposit interest rates, drove up the interest margin on dinar sources.

Chart IV.1.6 **Lending rates on FX loans and corporate and household deposits***
(weighted average values, p.a., in %)



Sources: NBS and European Banking Federation.

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

** Euro and euro-indexed.

The interest margin on FX sources also increased in Q3.

The weighted average rate on new dinar loans was up 1.4 pp to 18.9% in September. Rates on corporate loans went up (by 1.7 pp to 17.7%), while rates on household loans declined (by 0.5 pp to 20.0%). The rise in the weighted average rate on dinar loans was also due to a changed structure in new dinar loans, as the share of household loans, which are more expensive than the corporate ones, increased significantly relative to June.

The rate on the most prevalent, dinar corporate loans for current assets, went up by 2.4 pp to 18.9% in Q3. A decline in rates on dinar household loans was due chiefly to a 0.4 pp drop in rates on cash loans – 20.0% in September. Rates on consumer loans lost 1.1 pp and came at 20.2% in Q3.

Rates on new euro and euro-indexed loans went up by 0.5 pp relative to June, to 7.2% in September. In the corporate sector, they rose by 0.5 pp to 7.0% in September. The rise was noted for all types of loans. Of this, rates on current assets loans were up 0.3 pp to 6.9%, investment loans 0.2 pp to 6.6%, and other loans 0.9 pp to 7.8%. Rates on household loans picked up by 0.4 pp to 8.1%, in respect of rising rates on consumer (by 0.2 pp to 6.3%), other (by 0.2 pp to 11.1%) and housing loans (by 0.3 pp to 5.2%).

The weighted average rate on new dinar corporate deposits fell by 0.3 pp to 9.0% in September. It also fell in the household sector, by 0.5 pp to 8.9%.

Rates on euro deposits also declined in Q3. Those on household euro savings were down by 0.5 pp to 2.8% in September, and those on corporate euro deposits by 0.4 pp to 2.1%.

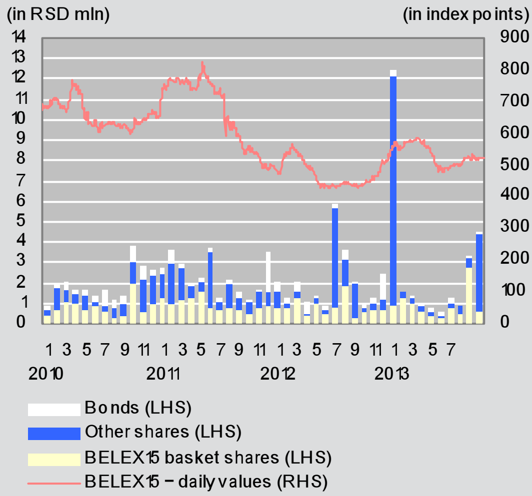
Stock exchange trends

Following contraction in Q2, BSE shares recovered in Q3.

Unlike stock exchange indices in the region, which started up in late Q2, the recovery of Belgrade Stock Exchange (BSE) indices began in July. Relative to end-June, BELEX15 edged up by 9.3% to 524.8 index points in late September. The general BELEXline index reached 1035.3 points by end-Q3, up by 8.3% on end-June. Having risen in Q3, end-September BSE indices stayed broadly at end-2012 levels – BELEX15 and BELEXline gained 0.2% and 3.0% relative to end-2012, respectively.

Rising share prices were accompanied with higher trading volumes on the BSE. Total trading in shares amounted to

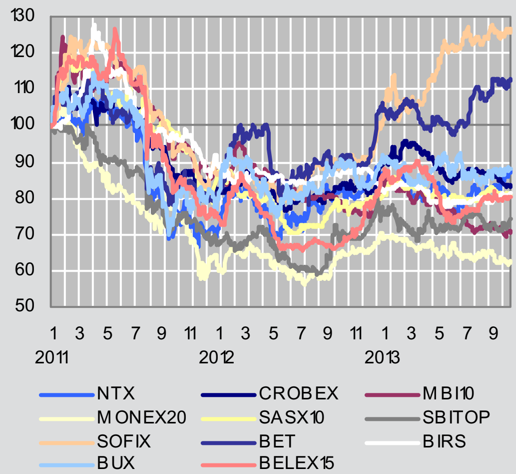
Chart IV.1.7 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

Following a decline in the previous quarter, share prices recovered in Q3.

Chart IV.1.8 **Stock exchange indices across the region**
(in index points, normalised, 31 Dec 2010 = 100)



Sources: BSE and regional stock exchanges.

In Q3, BSE indices rose to a higher degree than indices of most stock exchanges in the region.

RSD 5.1 bln in Q3, up by RSD 3.3 bln on Q2. Trading volumes reached RSD 3.3 bln in September alone, most of which relating to a small number of transactions and shares trading. Trading in shares covered by BELEX15 equalled RSD 4.0 bln, up by RSD 2.7 bln on Q2.

Foreign investors gave a significant contribution to an increase in trading volumes. Over the entire Q3, they were more active on the sale than purchase side, triggering net sales of RSD 1.4 bln. Their withdrawal was due mainly to the global reaction to hints at tapering of the quantitative easing program, which swept across most developing markets.

Trading in frozen FX savings bonds, most notably those maturing for redemption next year, amounted to RSD 0.4 bln. Relative to Q2, trading volumes contracted by 17.4%, partly due to the redemption of A2013-series bonds in May. Yield to maturity rates rose slightly from end-June and ranged from 4.1% for A2015-series to 4.3% for A2014-series.

Corporate bonds were not traded in Q3 either.

BSE market capitalisation contracted by RSD 5.2 bln to RSD 750.3 bln in September. The share of market capitalisation in estimated GDP[6] was down 0.6 pp to 20.8% in September. Broken down by segment, regulated market capitalisation fell by RSD 8.4 bln to RSD 412.0 bln, as a result of weaker Open Market[7] capitalisation. MTP[8] capitalisation was up RSD 3.1 bln to RSD 338.3 bln.

In the region, only Bucharest indices rose more (14.8%) than BSE ones. Indices of most other stock exchanges in the region changed negligibly, while those in Skopje and Podgorica tumbled the most (6.4% and 7.7% respectively).

In the course of October, BSE indices changed slightly – BELEX15 lost 0.3% and BELEXline was up 0.1%. Total trading in shares increased relative to September, but on account of one block transaction of ownership change. Indices on regional stock exchanges recorded smaller changes in either direction.

[6] Estimated GDP over the last four quarters.

[7] A regulated market segment, consisting of shares not eligible for BSE listing. The listing is divided into prime listing (the highest quality) and standard listing (other shares meeting the listing requirements).

[8] MTP is the multilateral trading platform, set up by the Belgrade Stock Exchange and incorporating currently listed shares of companies not eligible for regulated market listing.

Monetary aggregates

Money supply rose in real terms in Q3, its dinar component in particular.

Total reserve money contracted by nominal 1.2% (real 0.7%) in Q3 as bank FX deposits with the NBS declined. Dinar reserve money went up slightly (0.3% in nominal and 0.8% in real terms), mainly on the back of elevated government spending and was withdrawn through open market operations and IFEM interventions.

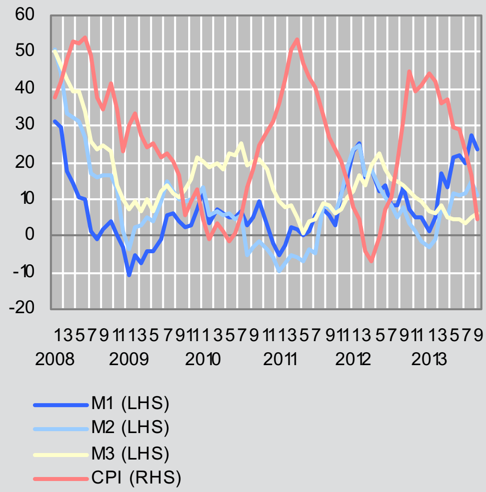
In the course of Q3, dinar reserve money was created chiefly in FX transactions – monetisation of government FX deposits (RSD 24.5 bln) and payment operations with Kosovo and Metohija (RSD 9.5 bln). Increased VAT collection (July saw record levels) diminished the government's impact on liquidity creation. The major portion of liquidity was absorbed through repo operations (RSD 20.0 bln) and NBS operations in the IFEM (RSD 13.8 bln).

In the structure of dinar reserve money, cash in circulation rose by RSD 3.7 bln. Excess bank dinar reserves[9] fell by RSD 7.8 bln as bank overnight deposits with the NBS declined. Required reserves allocated in dinars rose by RSD 0.6 bln. Balances in dinar accounts of local government authorities with the NBS went up by RSD 4.5 bln as a result of the withdrawal of their deposits from banks.

Money supply increased in real terms in Q3, particularly for M1 (9.9%), because of rising transaction deposits of corporate and household sectors. As a result, despite a mild decline in savings and term deposits, money supply M2 gained 6.0% in real terms. Besides, the rise in FX deposits pushed up the broadest monetary aggregate M3 by real 3.3%.

Rising net FX reserves of banks (increased external receivables and reduced external obligations) had the strongest impact on M3 growth in Q3. By selling securities to banks and spending FX deposits with the NBS, the government also propped up M3. In contrast, reduced private sector lending, notably to corporates, exerted the strongest negative influence on M3.

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



Sources: SORS and NBS.

Money supply rose in real terms in Q3 owing to a slowdown in y-o-y inflation.

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

	2012	2013			Share in M3 Sep. 2013 (%)
	Dec.	March	June	Sep.	
M3	-2.5	-2.7	-4.8	1.2	100.0
FX deposits	2.2	-2.5	-7.1	-0.8	69.5
M2	-12.2	-3.2	0.9	5.9	30.5
Time and savings dinar deposits	-21.1	-15.8	-14.7	-13.4	9.4
M1	-6.3	5.2	11.0	17.8	21.0
Demand deposit	-1.6	18.1	21.9	30.8	14.4
Currency in circulation	-13.7	-14.1	-5.8	-3.2	6.6

Source: NBS.

Broken down by M3 component, demand deposits rose the most (RSD 26.8 bln), notably those of corporate and household sectors. The sharpest growth was recorded for transaction accounts of enterprises from electricity

[9] Including balances in bank gyro accounts, vault cash and overnight deposits with the NBS.

distribution, mining and manufacturing sectors. Dinar household savings continued up in Q3, by 12.7% (RSD 2.6 bln), notably deposits maturing between six months and one year, and demand deposits. Y-o-y growth in dinar savings accelerated as of May and reached 30.5% in September. However, despite an increase in dinar household savings, savings and term deposits declined by RSD 3.5 bln, primarily as a result of falling balances in accounts of companies and local government authorities, whose revenue contracted partly due to the income tax reduction. FX deposits rose RSD 19.0 bln expressed in dinars, or 127.0 mln expressed in euros. This was prompted by increased balances in FX corporate accounts and FX household savings which, following a drop in Q2, gained EUR 43.5 mln in Q3.

As inflation subsided, real y-o-y growth in monetary aggregates accelerated in Q3. M1 recorded the largest y-o-y growth (17.8%) in September, following changes in the maturity structure of dinar deposits in favour of transaction deposits. M2 rose 5.9% in y-o-y terms, while a y-o-y drop in M3 was halted in late Q3 and this aggregate gained real 1.2% in September.

Monetary multiplier increased by 0.1, measuring 1.1 and 1.6 for M1 and M2 respectively. As transaction deposits increased, the velocity of circulation of dinar monetary aggregates slowed, but kept its q-o-q pace for M3.

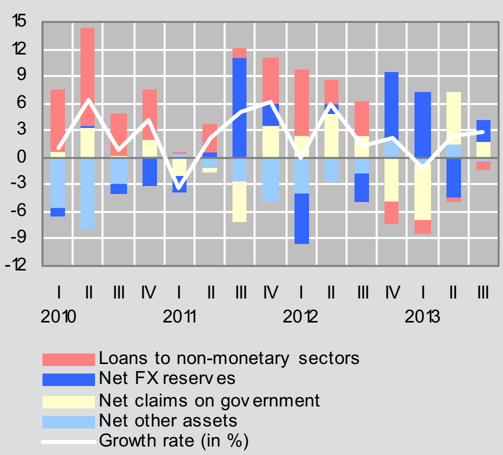
Bank lending

A quarterly decline in lending continued into Q3. After an extended period of sluggish growth, lending contracted y-o-y, on account of falling corporate loans. In contrast, growth in household lending continued.

Reduced extension of new loans as of early 2013 bore down on y-o-y lending figures. In September, excluding the exchange rate effect[10], bank loan receivables fell 3.8% y-o-y. Lending declined y-o-y also excluding receivables of banks delicensed in October 2012 and April 2013.

Having entered the zone of y-o-y contraction in lending, Serbia joined in Q3 the group of countries of Central Eastern Europe which have been recording negative growth rates[11] for some time already.

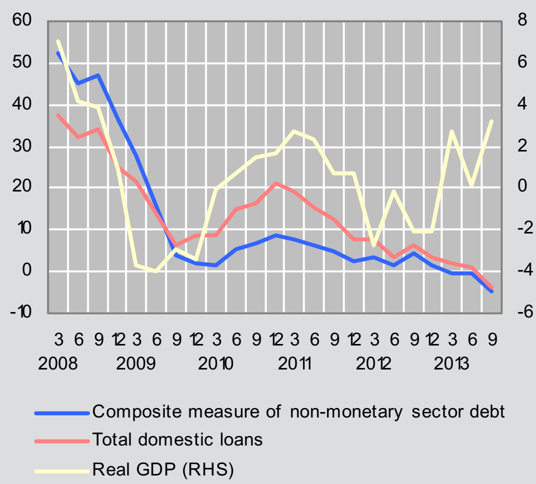
Chart IV.1.10 **Contribution to M3 3-month growth rate**
(in percentage points)



Source: NBS.

A rise in net FX reserves of banks and net claims on the government drove up M3, while the negative impact of lending activity continued into Q3.

Chart IV.1.11 **Lending activity and GDP**
(y-o-y rates, in %)



Sources: NBS and SORS.

Following several years of sluggish growth, lending activity recorded a y-o-y decline in Q3.

[10] Calculated at the RSD/EUR exchange rate on 31 August 2008, assuming that all FX and FX-indexed loans were extended in euros.

[11] Lending growth is sluggish even in Poland, a country that avoided recession.

In quarterly terms, lending continued down for the fourth consecutive quarter. Excluding the exchange rate effect, domestic lending fell 1.1% in Q3, mainly as a result of reduced corporate lending. The share of loans in estimated GDP[12] declined by 1.6 pp to 51.2% in late Q3.

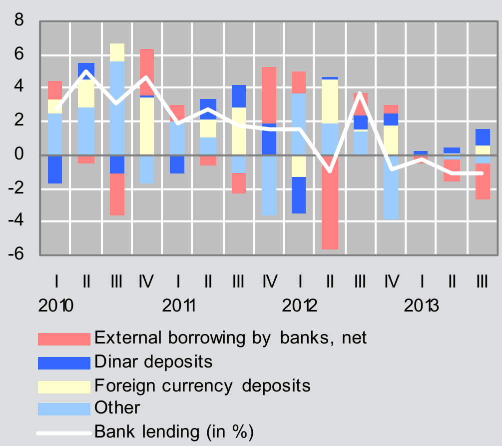
In terms of bank sources of finance, dinar and FX corporate and household deposits[13] went up. Banks held somewhat lower balances with the NBS in respect of FX required reserves and secured a portion of funds from increased capital. In the review period, banks opted for non-risk investment, notably in repo securities. They also transferred a portion of funds to accounts abroad. Their receivables from loans to non-residents increased and external credit liabilities contracted.

Excluding the exchange rate effect, corporate loans fell 2.8%, or RSD 26.9 bln in absolute terms. Since early 2013, corporate lending decreased RSD 71.9 bln or 7.1%. This was partly due to the assignment of bank receivables to entities outside of the financial system. Loan repayments exceeded fresh loan disbursements, primarily as a consequence of deteriorated creditworthiness, tighter lending standards and lower demand for loans. In Q3, new loans fell by around 5% q-o-q or by 1/3 y-o-y. A reduction was observed for all types of loans. Among new loans, current assets and investment loans were the most dominant. Banks did not approve subsidised corporate loans in Q3 as the subsidised corporate lending programme was suspended in March.

By contrast to the corporate sector, household lending continued up in Q3, adding RSD 6.8 bln or 1.6%, excluding the exchange rate effect. Cash loans, mainly dinar, were prevalent. Housing and consumer loans were used to a lesser extent than in Q2. The most expensive form of borrowing – credit cards and current account overdrafts, rose somewhat relative to Q2. Subsidised household lending continued in Q3, with banks approving housing loans worth RSD 3.3 bln.

The share of dinar in total corporate and household loans fell 0.2 pp from June to 27.3% in September. The share of dinar household loans continued up, by 0.9 pp from June to 37.4% in September. It fell 1.0 pp to 21.3% in the corporate sector.

Chart IV.1.12 **Contributions to quarterly rate of lending growth***
(in pp)

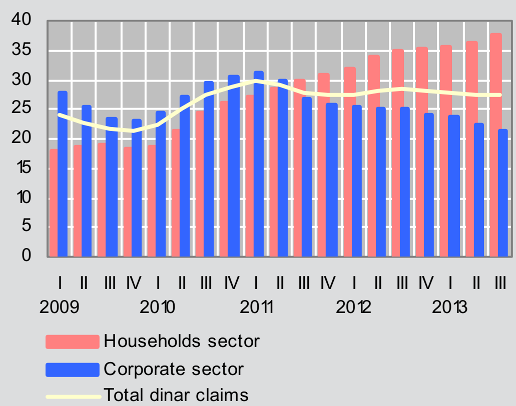


Source: NBS.

* Loans to non-monetary sectors excluding the exchange rate effect.

Despite a rise in domestic deposits, a rise in net external bank claims impacted on lending activity.

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



Source: NBS.

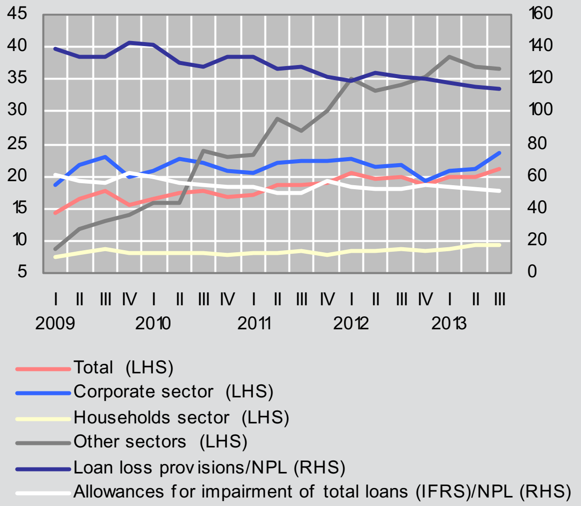
* Excluding the exchange rate effect.

In the course of Q3, the degree of dinarisation of claims on the household sector increased, while declining in the corporate sector.

[12] Estimated GDP for the last four quarters.

[13] A rise in the deposit base and reduced lending dragged down the LTD ratio, to 118.2% in September.

Chart IV.1.14 **NPL share in total loans, gross principle**
(%)



Source: NBS.

The NPL share increased in Q3.

The ratio of NPLs in total loans (gross principle) rose 1.1 pp from June to 21.1% in September. The NPL share rose 2.3 pp to 23.5% in the corporate and 0.1 pp to 9.4% in the household sector. Having amended regulations in December 2012, the NBS adopted measures to resolve the NPL issue. These measures enable the assignment of bank due receivables to entities outside of the financial sector and should help release funds (earlier created loan loss provisions) for the purpose of financing viable projects and clients. From January to October 2013, based on information that the NBS received from banks, the receivables assigned totalled RSD 27.7 bln (close to EUR 242 mln). Excluding receivables assigned to other banks within Serbia's banking sector, the total value of assigned receivables was RSD 19.9 bln. The above testifies that NBS measures have already yielded some results, but their full effect is yet to materialise.

Despite a high NPL share in total loans, the capital adequacy ratio of 19.9% in September indicates unimpaired stability of the domestic banking sector. Allowances for impairment equalled 51.2% of NPLs in September. At 113.9% in September, loan loss provisions fully covered the level of gross NPLs.

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

Following depreciation in Q2, the dinar exchange rate was relatively stable in Q3.

The exchange rate for the dinar was stable in the first half of Q3. Depreciation pressures emerged by mid-August, intensifying in the first and subsiding in the second half of September. By end-Q3, the dinar weakened somewhat against the euro (by 0.4%) relative to end-June. In Q3, the dinar lost 1.8% on average against the euro q-o-q.

Dinar's depreciation against the euro, as well as weakening of the dollar against the euro, prompted the dinar's depreciation of only 0.3% against the dollar on average. End-period, the dinar gained 3.0% against the dollar.

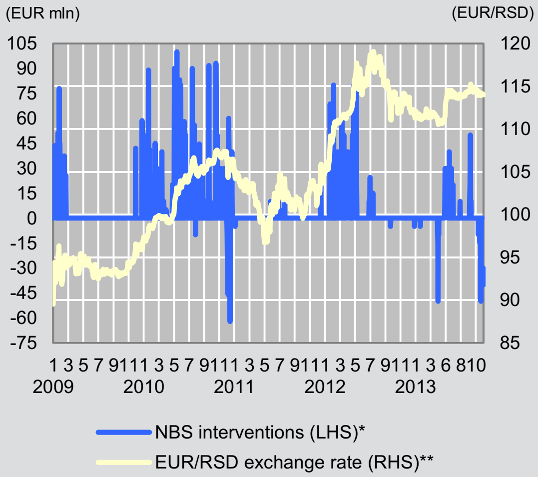
Consistent with these trends, the nominal effective exchange rate of the dinar[14] weakened by 1.5% on average in Q3. Nominal depreciation of the exchange rate, along with falling domestic and rising foreign prices, spurred a 1.4% depreciation of the real effective exchange rate of the dinar (1.6% against the euro, 0.7% against the dollar).

Following the June instability driven by uncertainties surrounding Fed's future quantitative easing policy, FX markets of Central and Eastern Europe stabilised in July. Depreciation pressures re-emerged in mid-August, triggered by FX purchases by non-residents, following the payment of NIS (Serbian Oil Company) dividends. By the end of the month, these pressures were amplified by global uncertainties associated with expectations of Fed's September meeting and the decision on possible downsizing of the quantitative easing program. Fed's deferral of the decision eased pressures in the Serbian FX market in the second half of September, when the dinar returned to its early September levels.

Domestic factors had an additional impact on the dinar in Q3. Owing to positive tendencies in foreign trade and increased corporate external borrowing, net FX sales to domestic companies were halved in Q3 relative to the previous quarter. At the same time, the FDI inflow increased from Q2, while net FX purchases from exchange offices and natural persons, though lower, remained above the average of previous years.

[14] Calculated as the geometric mean of nominal exchange rates of EUR/RSD and USD/RSD, with respective weights of 0.8 and 0.2, i.e. according to the formula: (EUR/RSD^0,8)*(USD/RSD^0,2).

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



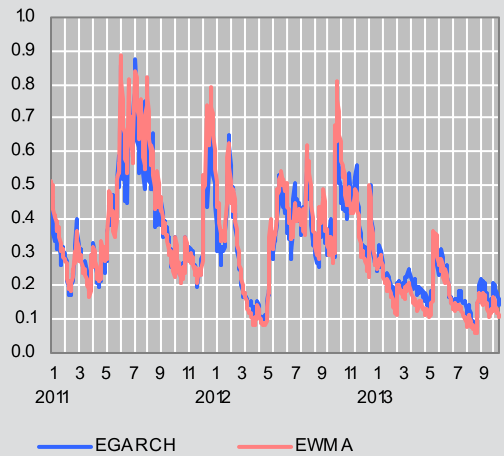
Source: NBS.

* + sale; - purchase.

** 1 EUR in RSD.

Having weakened in late Q2, the exchange rate of the dinar stabilised at a higher level in Q3.

Chart IV.2.2 **Short-term volatility of the RSD/EUR exchange rate**
(in %)



Source: NBS.

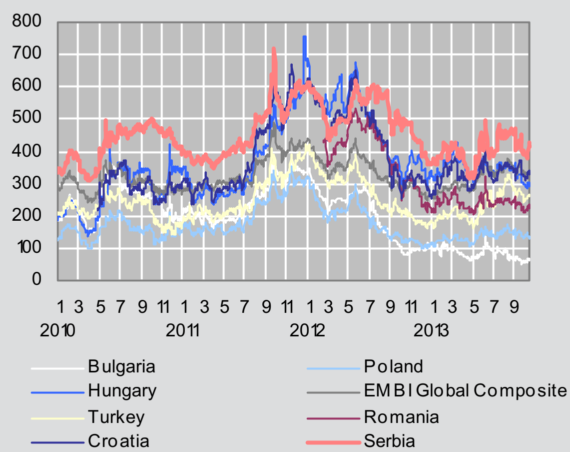
Oscillations of the dinar exchange rate against the euro recorded low values in the course of Q3.

In the course of Q3, average daily trading volumes in the IFEM equalled EUR 30.0 mln, the lowest value recorded over the last three and a half years. Trading volumes were relatively the same over the entire three months. Exchange rate volatility, measured by EWMA[15] and EGARCH[16], was consistent with IFEM developments. Over the entire quarter, exchange rate volatility was at a low level, the lowest being observed in August.

To ease excessive daily volatility of the dinar, the NBS intervened in Q3 selling a total of EUR 120.0 mln, first in early July and then at end-month, and several times around mid-September. It also continued to organise three-month and two-week FX swap auctions. At three-month swap auctions, it bought EUR 6.0 mln and sold an equal amount. At two-week auctions, it bought EUR 15.0 mln and sold an equal amount.

After fiscal consolidation measures were announced, non-resident participation in the primary market of government securities rose significantly in October, for the first time in four months. This contributed to mild strengthening of the dinar against the euro (0.5%) and the NBS purchased EUR 165.0 mln in the IFEM.

Chart IV.2.3 **Risk premium indicator – EMBI by country**
(daily data, in bp)



Source: JP Morgan.

EMBI for Serbia mirrored the regional dynamics, with somewhat sharper oscillations in both directions.

[15] EWMA – Exponentially Weighted Moving Average.

[16] EGARCH – Exponential General Autoregressive Conditional Heteroskedastic.

Risk premia of countries in the region, measured by EMBI, largely reflected market expectations and responses to Fed's monetary policy. Following the initial fall, EMBI was stable in July, but increased again by the end of the month in expectation of a new meeting. A sharp fall, though temporary for most countries, ensued in mid-September after the Fed's unexpected decision to keep the volume of the existing quantitative easing program.

EMBI for Serbia mirrored the regional dynamics, with somewhat sharper changes in both directions compared to other countries. EMBI varied particularly in response to domestic factors: positive news of initiation of Serbia's EU accession negotiations and the first intergovernmental conference to be held most probably in January 2014, as well as adverse assessments of Serbia's public finance. In late September, EMBI for Serbia equalled 432 bp, down by 8 bp on end-June. A steeper fall was recorded for risk premia of Bulgaria (49 bp), Romania (29 bp) and Hungary (23 bp). In terms of the quarterly average, EMBI for most countries in the region went up, most notably for Turkey (67 bp) and Serbia (50 bp).

In late October, EMBI for Serbia came at 430 bp, down by 2 bp from end-September. In October, Standard & Poor's confirmed Serbia's rating at BB-, while keeping the negative outlook.

Of other currencies under similar exchange rate regimes, the Turkish lira and Hungarian forint weakened more than the dinar (8.6% and 1.1% respectively, vs. 0.4%), whilst the Polish zloty and Czech korona bounced back (2.7% and 0.8% respectively).

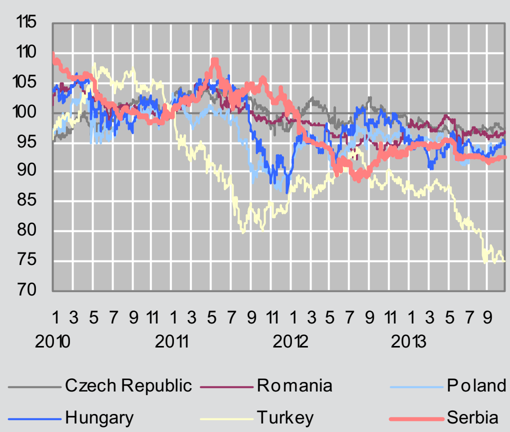
Foreign capital inflow

Capital inflow was recorded in Q3 on account of FDI and government and corporate borrowing, while capital outflow was triggered by portfolio investments and a reduction in credit liabilities of the NBS and banks.

Net inflow from FDI totalled EUR 223.8 mln in Q3 and is the highest quarterly inflow in 2013. In the year to September, net inflow on this account equalled EUR 518.1 mln. A bulk of investments in Q3 was directed into manufacturing (24.3%), financial services (22.1%) and retail and wholesale enterprises (21.5%).

Portfolio investments accounted for a net outflow of EUR 109.3 mln, while an inflow of EUR 945.6 mln was noted on the same account from the beginning of the year, primarily due to government borrowing through Eurobond issues in the international financial market. A slump in non-resident interest in government securities and their reluctance to invest in domestic securities were present during most of Q3. The announced consolidation measures in Serbia's public finances and

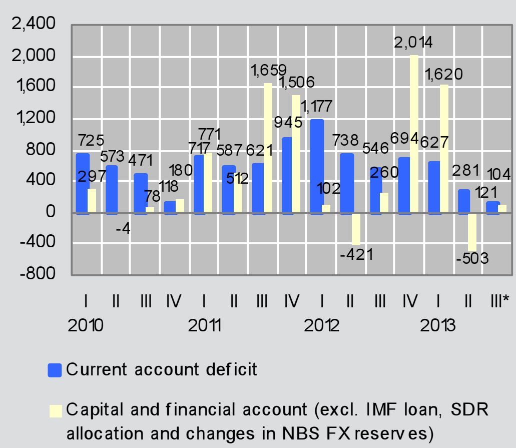
Chart IV.2.4 **Movements in exchange rates of national currencies against the euro***
(daily data, 31 Dec 2010 = 100)



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

End-of-period, the dinar was among the currencies witnessing the smallest change in value in Q3.

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



Sources: SORS and NBS.
* Preliminary data.

Despite a modest capital inflow in Q3, there were no major pressures in the FX market because of the exceptionally low current account deficit.

the September decision to delay QE tapering reflected favourably on foreign investors' readiness to invest in the domestic securities market. Indications of their growing presence in the domestic market, observed around the end of Q3, were substantiated by October developments.

Net foreign borrowing by residents under financial loans totalled EUR 136.5 mln in Q3 and net repayments since the beginning of the year EUR 183.5 mln. Government net liabilities under financial loans rose the most, by EUR 269.8 mln. Of this, EUR 233.1 mln pertains to a Russian Government loan for budget support and the rest to loan disbursements from the European Investment Bank and the Council of Europe Development Bank. In the year to September, government financial borrowing rose by EUR 473.5 mln. Enterprises increased their liabilities under financial loans by EUR 45.9 mln net in Q3 while repaying EUR 99.2 mln net in the year to September. Q3 saw banks reduce their net foreign liabilities by an additional EUR 179.1 mln, or by a total of EUR 557.9 mln from the start of the year.

Corporate trade credits were up by EUR 42.1 mln.

To service its foreign liabilities, the NBS paid out a total of EUR 180.3 million in Q3, of which EUR 175.3 mln was used for regular debt payment to the IMF. In the year to date, total debt payment to the IMF has reached EUR 469.8 mln.

3. Aggregate demand

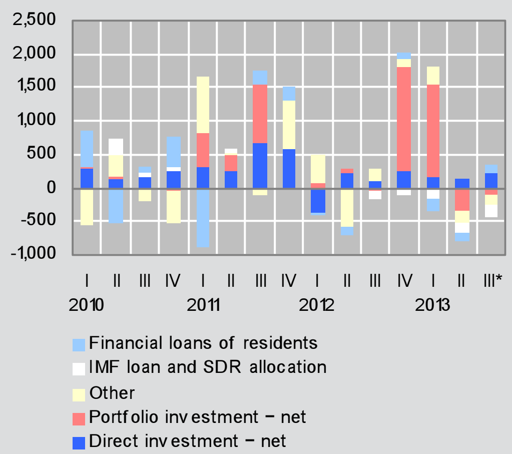
Aggregate demand rose in Q3 entirely in response to rising net exports, while domestic demand continued to weaken in Q3.

Following a drop in Q2 (0.5% s-a), aggregate demand increased by 1.1% in Q3, boosted again by net exports (1.6 pp), which rose 8.2%. On the other hand, domestic demand declined again (0.4%), giving a negative contribution of 0.5 pp. As a result, the tendency towards structural adjustment of the entire economy continued – i.e. economic growth based on higher net exports and lower domestic consumption.

According to the Statistical Office estimates, total demand also rose in y-o-y terms (3.2%) in Q3. Robust y-o-y growth in net exports continued (33.5%), giving an impetus to total demand with 7.8 pp. Hence, a 4.6 pp negative contribution of domestic demand, which fell by 3.7% y-o-y in Q3, was completely offset.

Owing to reassuring trends in foreign trade since the beginning of the year, which exceeded expectations stated in the August *Inflation Report*, the projected growth in aggregate demand for the on-going year lingered around 2.0% despite a steep fall in investment. In our best judgement, annual growth will be entirely powered by net exports (5.7 pp), as indicated by real growth in

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

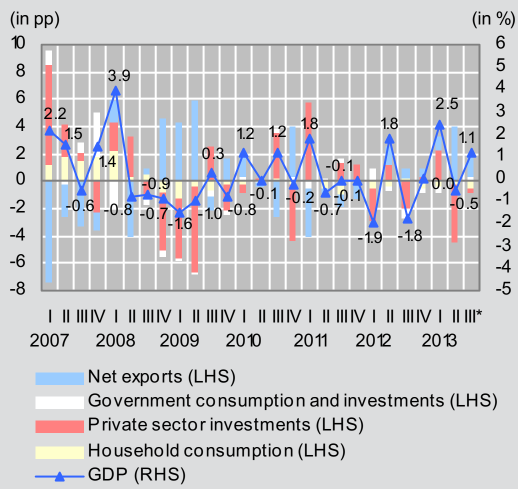


Sources: SORS and NBS.

* Preliminary data.

Net capital outflow was much lower relative to Q2, owing to an FDI inflow and borrowing under financial loans.

Chart IV.3.1 **Contributions to quarterly GDP growth rate – expenditure side**



Sources: SORS and NBS calculation.

* NBS estimate.

GDP grew in Q3 not only on the back of net exports, but also on the back of elevated government consumption.

commodity exports in the year to September, which reached as much as 22.0% y-o-y, and modest real growth of commodity imports of 4.7% y-o-y. By contrast, all domestic demand components will produce a negative contribution of 3.7 pp to total demand in 2013.

Domestic demand

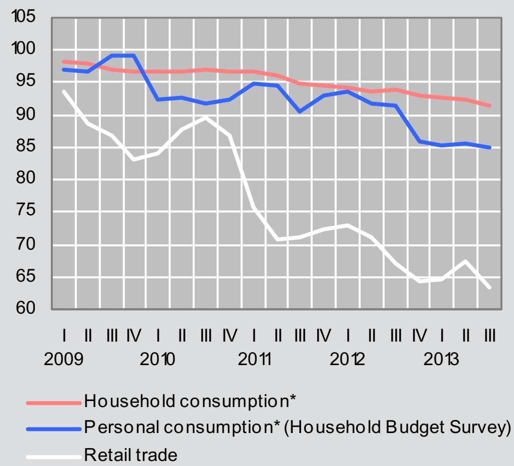
Household consumption and private investment were the main cause of the fall in domestic demand in Q3.

According to our estimates, **private consumption** continued to subside in Q3 (2.3% y-o-y), producing a negative contribution of 1.8 pp to total demand. High unemployment and low household income are still the main obstacles to growth of private consumption.

Private consumption recorded a quarterly drop of 0.8% s-a, as indicated by movements in retail trade (down by 6.1% s-a) and catering volumes, as well as by a fall in VAT receipts.

In terms of sources of consumption, wages and pensions recorded real drop, while the announced fiscal consolidation measures, focused on cutting down above-average take-home pay in the public sector and indexing wages and pensions, will delay the recovery of consumption. The announced increase in special VAT rate could also lead to a drop in private consumption.

Chart IV.3.2 **Household consumption**
(s-a data, H1 2008 = 100)



Sources: SORS and NBS calculation.

* NBS estimates for Q3 2013.

The downward trend in household consumption, in place since early 2013, continued into Q3.

Table IV.3.1 **Investment indicators**

	2012		2013		
	Q3	Q4	Q1	Q2	Q3
Real indicators (seasonally-adjusted, quarterly growth, in %)					
Construction	-13.5	-14.1	-6.0	-16.5	-1.6*
Industrial production of capital goods (physical volume)	4.4	-1.7	29.5	5.2	4.4
Exports of capital goods**	-3.9	0.3	9.2	-14.3	13.1
Imports of capital goods**	-1.8	-8.0	2.2	-3.8	-7.6
Stocks of capital goods	1.8	3.1	-1.0	5.6	-1.9
Industrial production of intermediate goods (physical volume)	-6.8	-1.5	-0.6	1.8	2.3
Exports of intermediate goods**	-4.5	0.3	4.3	2.7	18.3
Imports of intermediate goods**	-1.1	0.8	0.6	-2.5	1.7
Stocks of intermediate goods	-3.1	2.1	4.7	2.8	4.3
Industrial production of construction materials (physical volume)	-3.1	-1.2	-5.7	-7.4	-0.5
Inventories of construction materials	2.1	0.7	-4.7	-0.3	-1.0
Government investment***	-6.9	9.1	-23.8	-2.1	6.1

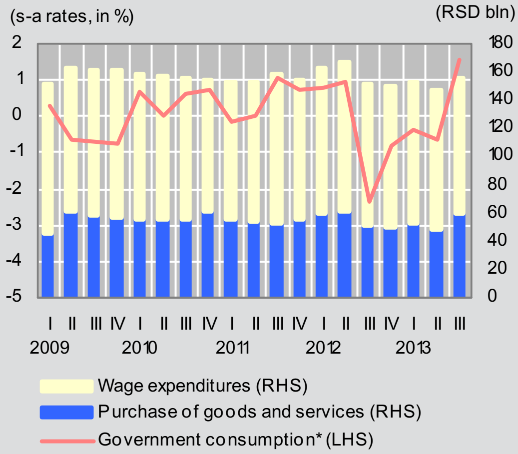
* NBS estimate.
** Exports and imports are denominated in euros.
*** Government investment spending is deflated by the industrial producer price index.

Private investment is estimated to have declined considerably in Q3 (11.3% y-o-y) and exerted the largest drag on aggregate demand (2.6 pp). In quarterly terms, private sector investment activity declined at a much slower pace (1.0% s-a) relative to Q2.

Almost all indicators suggest a downturn in Q3 investment activity. The construction sector and building materials production continued to contract and equipment imports shrank for the second consecutive quarter. On the other hand, corporate lending declined, while FDI inflow rose and corporate foreign borrowing edged up slightly.

After a one-year decline, **government consumption** perked up by 1.6% s-a in Q3 (contribution 0.3 pp), as evidenced by the real increase in outlays for goods and services and a decrease in outlays for public sector wages. A mild 1.4% increase in government consumption was also recorded in y-o-y terms (contribution 0.3 pp). Nonetheless, in accordance with the announced fiscal consolidation measures, this demand category is also expected to contract in the period ahead.

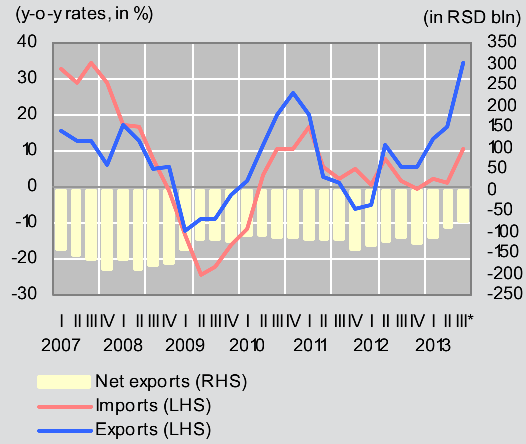
Chart IV.3.3 **Government consumption**
(in real terms)



Sources: SORS, Ministry of Finance and NBS calculation.
* NBS estimate for Q3 2013.

Elevated government consumption was prompted by higher expenditure for the purchase of goods and services.

Chart IV.3.4 **Exports and imports of goods and services**
(in previous-year constant prices, ref. 2005)



Sources: SORS and NBS calculation.
* NBS estimate.

Net exports continued to rise vigorously y-o-y in Q3 and gave a positive contribution to rising demand.

As indicated by consolidated capital expenditure, the fall in **government investment** decelerated y-o-y to 13.5% and stagnated q-o-q (-0.1% s-a). Although higher investment is desirable in times of sluggish economic growth, it will be rather limited in the foreseeable future due to the fiscal consolidation process.

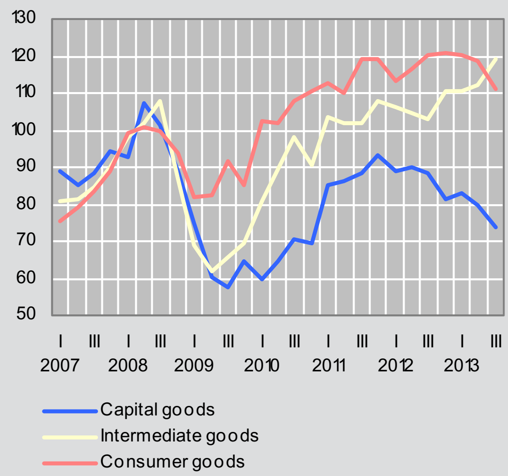
Net external demand

Net external demand continued to support aggregate demand in Q3, thanks to the further rise in exports of manufacturing industry and the recovering exports of agricultural products.

As real exports continued to rise relentlessly (12.0% s-a) and imports also stepped up (6.2% s-a) in Q3, net external demand increased by 8.2% s-a. At y-o-y level, real exports and imports accelerated as well (34.6% and 10.6%, respectively), and net external demand ended the third quarter 33.5% higher than the same quarter last year. Such a strong growth in net exports reflects continuing expansion of the automobile industry, the recovery of agricultural exports and the substitution of petroleum product imports.

The 17.1% s-a growth in euro-denominated commodity exports indicates further export expansion. The largest contribution to the upward trend in commodity exports is still coming from motor vehicle exports, which rallied by 38.0% s-a and increased their share in total exports to 18.7%. The value of exports of Fiat Automobiles Serbia

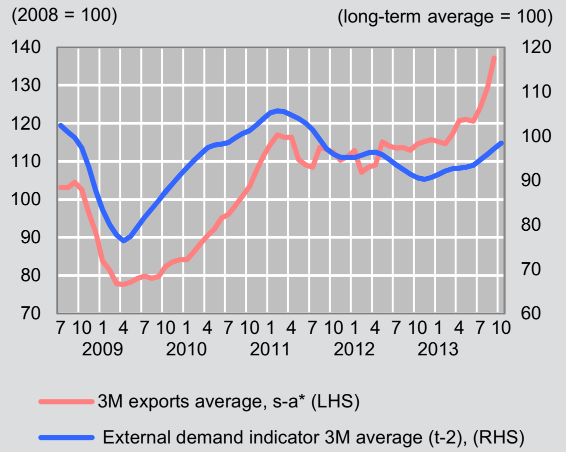
Chart IV.3.5 **Imports by key component**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Imports of intermediate goods continued to rise s-a in Q3, while imports of equipment and consumer goods declined.

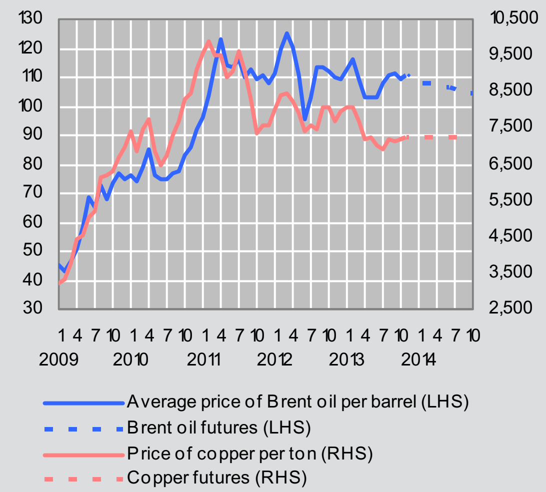
Chart IV.3.6 **External demand and Serbian exports**



Sources: European Commission, SORS and NBS.
* Excluding automobile industry.

The economic recovery of Serbia's main foreign trade partners boosted domestic exports.

Chart IV.3.7 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

Global oil prices increased in Q3 as geopolitical tensions deepened in the Near East.

in the year to September reached EUR 1.1 bln and is for the time being in line with our projection.

Q3 also saw a hefty rise in the exports of agricultural products – 139.8% s-a. The most important product in this respect was wheat, rising nearly thrice in volume terms over the same period last year. Corn exports have also picked up since September with the arrival of new, better-quality crops.

Good agricultural performance had a beneficial impact on the food industry, whose exports went up by 8.9% s-a in Q3. Base metals, electrical equipment and articles of apparel remained positive contributors to export growth, while exports of pharmaceutical products, non-ferrous metals and other machinery and equipment recorded a decline.

Euro-denominated commodity imports gained 3.1% s-a in Q3. The strongest growth was recorded for imports of intermediate goods (6.0%), while imports of equipment and consumer goods contracted by 7.6% and 6.4% s-a, respectively. In terms of economic destination, a rise was recorded for imports of energy (10.3% s-a) and intermediate goods (5.4% s-a) and a fall in imports of durable consumer goods (10.7% s-a).

Indicators of the balance of payments position improved further. At end-Q3, commodity exports were 67.0% higher and imports 2.9% lower than pre-crisis[17]. At the same time, the export to import ratio spiralled further up to the record 71.0%[18] in September.

The upturn in domestic exports is consistent with the movements of the indicator of external demand for Serbian exports[19]. This indicator marked an increase in Q3, which can be linked to the nascent economic recovery in a large number of Serbia's important trade partners.

Brent oil edged up by 6.8% relative to the previous quarter. The price growth, which began in late June, persisted until September and was led primarily by the mounting geopolitical tensions in Egypt and Syria. Once these tensions subsided and uncertainties over US fiscal movements dissipated, the price of oil fell to around USD 110.0 per barrel, where it stayed in October as well.

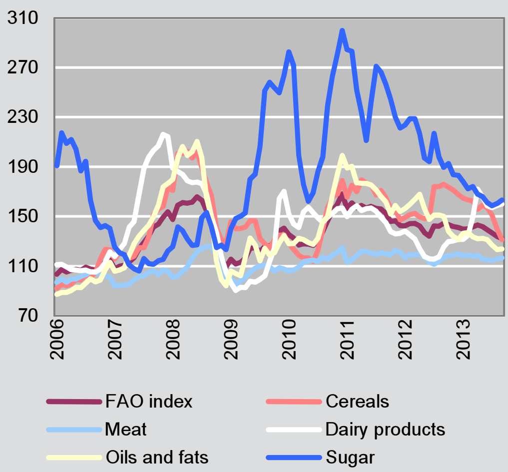
The average price of copper in international markets in Q3 was roughly the same as in Q2. The price of copper fell in July amid global uncertainties in commodity markets. However, driven by increased demand from

[17] H1 2008.

[18] 12-month moving average.

[19] Leading indicator of external demand for Serbian exports was construed based on movements in the European Sentiment Indicator (ESI). It includes 20 of Serbia's most important foreign trade partners – their shares in Serbian exports being used as weights.

Chart IV.3.8 **World food price index**
(in real terms, 2002 – 2004 = 100)



Source: FAO, UN.

Q3 saw a further decline in the world food price index, led by lower prices of cereals following a good agricultural season.

China in August and September, it bounced back to its Q2 level.

Cereal prices plummeted by 16.3% in Q3, dragging the FAO Food Price Index down by 5.1% relative to June. In addition to cereals, vegetable oils also recorded a decline, while other Index components (meat, dairy and sugar) inched up.

Text box 2: Impact of new economic policy measures on main macroeconomic indicators in 2014

The government unveiled in October new economic policy measures[1] to ensure public finance sustainability. The measures include: cutting employment numbers, introduction of the solidarity tax on net public sector income (20% on wages above RSD 60,000 and 25% on those above RSD 100,000), an increase in the special VAT rate (from 8% to 10% on staples, and 20% on IT equipment and hotel services), restructuring of public enterprises and reducing their subsidies, economising on goods and services, loan refinancing, and enhancing the business environment. The measures would bring down the budget deficit by around 1.5% of GDP. The question raised in this context is the impact on the main macroeconomic indicators next year – inflation, GDP and the balance of payments.

A higher special VAT rate will have a direct, one-year impact on y-o-y inflation. Assuming that prices of products and services subject to a higher VAT rate, increase by the full amount of the tax hike, the one-off effect on inflation is estimated at 0.7 pp. However, we have assumed in our inflation projection that a part of the VAT increase will be absorbed in lower trade margins (apart from administered prices with the assumed 100%). Namely, the spillover would be 60% on food prices (experience to date) and 80% on prices of IT equipment and hotel services (because of the relatively higher value of these products/services and a larger VAT change relative to food products). Under these assumptions, the one-off effect on inflation would equal 0.5 pp. The second-round effects of the VAT hike on prices will be small, i.e. limited by the producers' opportunity to raise prices against the background of low domestic demand.

The impact of new economic policy measures on GDP will drag down household and government consumption in the short run. The negative contribution of household and government consumption to GDP next year is estimated at 0.9 pp and around 0.1 pp respectively.

The announced measures are expected to prevent widening of the current account deficit next year. Despite higher interest costs, fiscal consolidation is likely to prompt smaller imports of consumer and intermediate goods, offsetting the increase in interest costs.

Though negative effects of new economic policy measures seem to prevail in the short run, these measures are indispensable for preservation of fiscal stability, i.e. for macroeconomic stabilisation. They are, moreover, of paramount importance in the setting of elevated uncertainties stemming from the external environment, when even the smallest doubt as to public finance sustainability may significantly increase investor aversion to a particular developing country. Besides, these measures would, in the long run, improve the investment climate and prop up economic growth.

[1] Measures were published in the Fiscal Strategy for 2014 with Projections for 2015 and 2016.

4. Economic activity

As positive trends in agriculture and several industrial branches continued into Q3, GDP recorded a 1.1% s-a growth despite adverse developments in construction and trade.

According to the Statistical Office flash estimate, the economy grew by 3.2% in Q3 relative to the same period last year, continuing the recovery that began in early 2013.

Relative to a quarter earlier, GDP rose by 1.1% s-a in Q3, while economic activity measured by NAVA inched up 0.9% s-a. This accelerated the rebound in economy to pre-crisis figures [20] – it dipped 1.0% measured by GDP and 1.7% measured by NAVA.

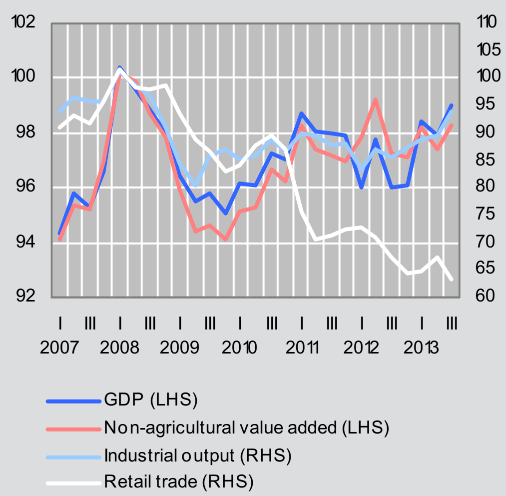
Growth in industrial production picked up in Q3 compared to the previous quarter. A 5.0% s-a rise in the physical volume of industrial production was primarily driven by growth in the sector of electricity, gas and steam supply of 18.1% (contribution 3.6 pp). The sectors of mining and manufacturing grew by 3.2% s-a and 1.4% s-a respectively, producing a contribution to total industrial growth of 0.4 pp and 1.1 pp respectively.

Decelerated growth in manufacturing can be attributed to seasonally lower production dynamics and nearly full output capacity of motor vehicles and petroleum products industries, branches that gave the largest boost to growth in the previous period. Quarterly rise in motor vehicle production slowed down to 5.0%, while the production of petroleum products fell by 4.5%.

The main boost to the physical volume stemmed from the production of chemical products, base metals and rubber and plastic products. Further, a good agricultural season laid the grounds for a recovery in food production. By contrast, the largest negative push came from the production of tobacco and metal products.

Besides industrial production, a positive contribution to quarterly GDP rise in Q3 came from the sectors of agriculture and information and telecommunications (0.1 pp and 0.4 pp respectively).

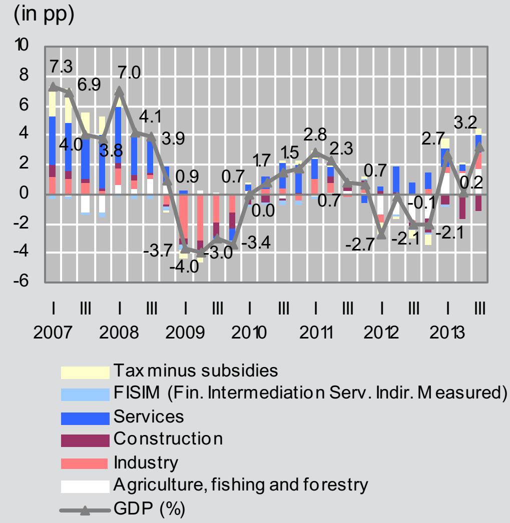
Chart IV.4.1 **Economic activity indicators**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Industrial production continued up in Q3, while retail trade volumes declined.

Chart IV.4.2 **Contribution to y-o-y GDP growth rate – production side**
(in pp)



Sources: SORS and NBS calculation.

A pick-up in agriculture and industry overpowered negative trends in the construction sector in Q3.

[20] H1 2008.

On the other hand, a negative impact is expected in response to dampened construction activity which is estimated to have dropped by 1.6% s-a in Q3, as indicated by the lower physical volume of building materials production. Further, a quarterly drop of 6.1% s-a in retail turnover points to a slack in the trade sector.

As in a quarter earlier, y-o-y growth of GDP in Q3 was led by the rise in agricultural (1.8 pp) and industrial production (1.0 pp). By contrast, the construction sector, which has been sliding for the past five quarters, continued to produce a negative contribution to GDP growth (-1.1 pp). The trade sector also exerted a negative impact (0.3 pp), though less than in H1.

In Q3, the growth of the physical volume of industrial production accelerated y-o-y to 10.5%. All three industrial sectors gave a boost to the physical volume, with the largest push (6.4 pp) coming from manufacturing, which rose by 8.4%. Electricity, gas and steam supply expanded by 20.5% and mining by 7.5% y-o-y, adding 3.2 pp and 0.8 pp respectively to the growth of the physical volume of total industry.

Robust y-o-y growth of the physical volume of production continued in the production of motor vehicles (172.0%) and petroleum products (149.8%), which gave the strongest positive push within manufacturing. As for other sectors, Q3 saw positive trends in the chemical and pharmaceutical industries and the production of base metals.

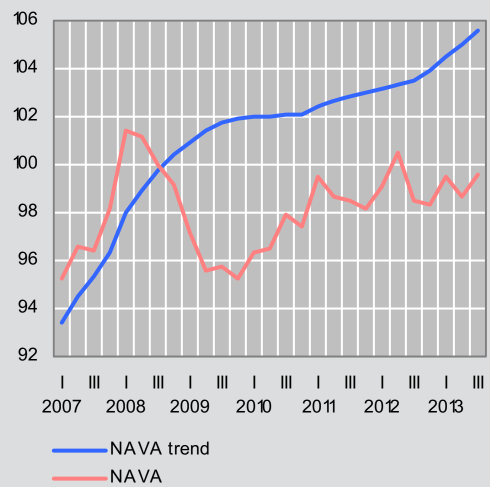
Economic growth in 2013 has been estimated at around 2.0% and will be powered mainly by the recovery in agricultural (1.5 pp) and industrial production (0.7 pp). On the other hand, a sharp drop of 35.0% in the construction sector will have an adverse effect on economic growth (-1.2 pp).

Favourable weather conditions were conducive to agricultural production which increased by around 20% in 2013. According to estimates of the Ministry of Agriculture, vigorous growth was recorded with the main crops (corn 62.2% and wheat 45.1%) and recovery was noted in the production of fruit (38.0%) and vegetables (16.4%). Good agricultural results will help alleviate inflation pressures from food prices.

We estimate that all industrial sectors will produce a positive contribution to GDP growth in 2013. Within manufacturing, a positive push is expected from continued expansion in the production of automobiles (1.0 pp) and petroleum products (0.5 pp), while most other branches will exert a negative impact due to the still languid economic recovery in the euro area.

The growth of the economic production potential[21], which took off at the end of 2012, continued into Q3. However, economic activity measured by NAVA grew at a brisker pace, leading to a slight narrowing of the negative output gap. Nonetheless, it is still indicative of strong disinflationary pressures on account of low aggregate demand.

Chart IV.4.3 **Output gap**
(Q3 2008 = 100)



Source: NBS calculation.

Economic recovery in Q3 impacted on moderate closing of the negative output gap.

[21] The NAVA trend estimated by Kalman filter is used for approximation of potential GDP.

Text box 3: EU pre-accession funds in Serbia

EU accession is Serbia's strategic priority and implies reforms to accelerate convergence of the economy and increase its capacity to face EU market competition pressures in the medium run. The reforms are also funded from the EU Instrument for Pre-Accession Assistance (IPA). The IPA was introduced in 2007 as a single channel of assistance to EU candidate and potential candidate countries[1] in meeting political and economic criteria and transposing the acquis communautaire. In the 2007–2013 fiscal cycle, the EU budget envisaged IPA funding worth EUR 11.5 bln. Of this, EUR 1.4 bln are earmarked for Serbia, or around EUR 200 mln a year.

The IPA is non-refundable EU assistance and is generally appropriated on budgetary funds already earmarked for reform purposes. Of total five components, Serbia has access to I and II components (transition assistance and institution building and cross-border cooperation). After gaining the EU candidate status in March 2012, Serbia met the first condition for accessing other IPA components (regional development, human resources development and rural development). It will meet the second condition once it receives accreditation to manage assistance itself (under the Decentralised Implementation System), i.e. once the management of IPA funds is transferred from the EU Delegation to national authorities, as expected by late 2013. Access to the rest of IPA components implies projects in the fields of transportation, regional development, support to SMEs, encouragement of employment, reform of the educational system, development of agriculture and villages etc.

Table O.3.1 **Funds allocated to Serbia under IPA components**
(EUR mln)

IPA component	2007	2008	2009	2010	2011	2012	2013	2007–2013
I Support for transition and institution-building	181.4	179.4	182.5	186.2	189.9	193.8	203.1	**1,316.3**
II Cross-border cooperation	8.2	11.4	12.2	12.4	12.7	12.9	11.6	**81.4**
III Regional development								
IV Human resources development								
V Rural development								
Total	**189.7**	**190.9**	**194.8**	**198.7**	**202.7**	**206.8**	**214.7**	**1,398.3**

Source*:* EU Delegation to Serbia.

Whether the funds allocated will be disbursed depends on the capacity of public and private sectors of each country. So far, Serbia has been relatively successful in using IPA funds, particularly in comparison with other Western Balkan countries. In the 2007–2012 period, Serbia agreed on the disbursement of IPA funds worth estimated EUR 1.3 bln[2]. The actual disbursement was lower (EUR 765.3 mln[3]), but it takes time, sometimes even two years after the date of agreement conclusion.

As shown by experiences of other countries in the EU accession process, the success in disbursing pre-accession funds is essential for the creation of capacities to efficiently absorb structural funds, which are far more important in terms of volume and which are intended for EU member countries[4]. According to the EU medium-term Financial Perspectives 2007–2013, the upper limit for structural funds for each member country is set at 3.6% of its GDP. If it were an EU member and given its current level of GDP, Serbia could receive around EUR 1.2 bln a year to support its economic development.

[1] EU candidate countries (Serbia, Montenegro, Macedonia, Turkey and Iceland) and potential candidate countries (Bosnia and Herzegovina and Albania).
[2] Data of the Intersectoral Development Assistance Coordination Network.
[3] Ibid.
[4] For instance, in the 2007–2013 period, Bulgaria will receive around EUR 7.0 bln, Slovenia around EUR 4.2 bln, and Germany around EUR 26 bln.

To define the strategic framework for IPA II, the Serbian Government and the European Commission are preparing the Country Strategy Paper for the next medium-term Financial Perspectives 2014–2020. Though probably the new seven-year EU budget will for the first time be smaller than the previous one, the European Commission proposed for IPA II the same amount as for IPA I. Having so far recorded a relatively high rate of absorption of EU pre-accession funds, and after gaining the EU candidate status last year and introducing the Decentralised Implementation System by the end of this year, we expect Serbia to be even more successful in the coming period. This will create the best basis for efficient use of much more significant structural funds in future.

5. Labour market developments

Wages

Public sector net wages registered real growth in Q3, while those in the private sector stagnated. Industrial unit labour costs recorded a fall in s-a terms.

The fall in inflation and the rise in average nominal net wage induced a 1.4% s-a growth of real net wages in Q3. Real wages increased in the public sector (3.5% s-a), while those in the private sector flatlined (0.1% s-a).

As in the previous quarter, the highest rise in real net wages was recorded in the information and communications sector, and those in the financial sector followed closely behind. Net wages in all industrial sectors continued up. After an entire year, wages in agriculture finally perked up. In contrast, a fall in net wages was noted in trade and construction, mirroring the contracted economic activity in these sectors. According to the results of the Ipsos September survey, most enterprises do not plan any increases in employee wages in the forthcoming three months.

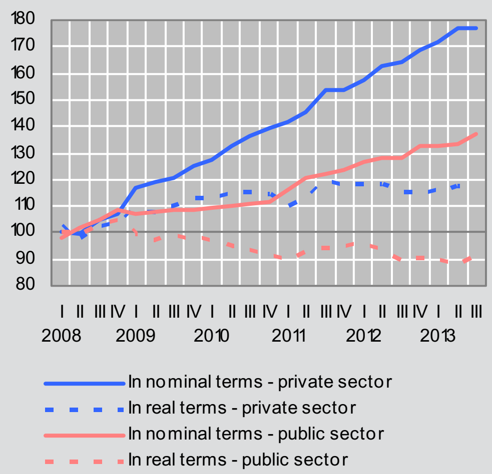
Y-o-y, real net wages declined marginally in Q3 (-0.3%). Relative to the same period last year, real net wages fell by 1.1% in the private sector, while those in the public sector stagnated.

Average nominal net wage in Serbia in Q3 dipped by 0.7% from Q2 – equalling RSD 43,925.

The Government's latest set of fiscal consolidation measures implies the introduction of a "solidarity tax" on public sector wages to be applied as of 2014 – 20% on wages above RSD 60,000 and 25% on those exceeding RSD 100,000.

Q3 witnessed a recovery in domestic industry's competitiveness. Industrial unit labour costs shrank by 6.0% s-a in Q3 in response to a 5.6% s-a rise in productivity and a 0.7% s-a decrease in real gross wages. Compared to pre-crisis figures[22], unit labour costs decreased by 9.5%. Within manufacturing, unit labour costs declined by 1.6% s-a due to productivity growing faster than real gross wages.

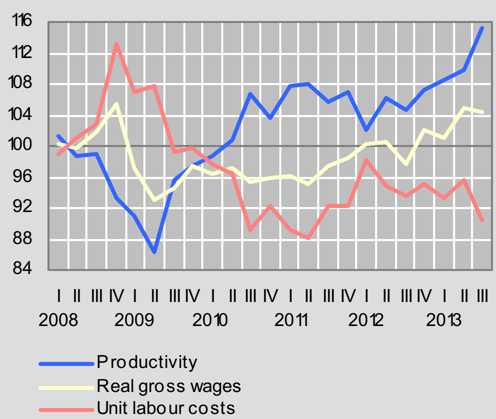
Chart IV.5.1 **Average net wages**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Real net wages increased in the public sector and stagnated in the private sector in Q3.

Chart IV.5.2 **Movements in productivity, real gross wages and unit labour costs in industry**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Competitiveness of the domestic industry, measured by unit labour costs, improved in Q3.

[22] H1 2008.

Employment

Labour market developments in Q3 were marked by a fall in unemployment figures and a decrease in the number of employed persons.

According to the National Employment Service data, September unemployment figures were down by 16,982 from June. In the same period, the Statistical Office recorded a decrease of 3,444 in the number of formally employed. This suggests that informal employment has expanded or that the activity rate has contracted further (a portion of the unemployed transferred to persons not actively seeking employment).

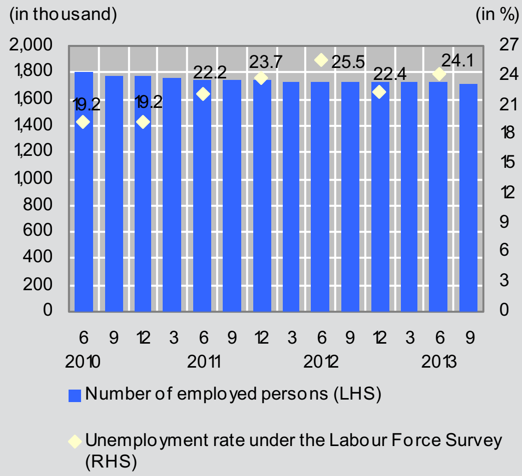
The Statistical Office data for Q3 indicate that employment declined in the private sector (4,079), but rose in the public sector (635). The largest private sector fall in employment was recorded in construction (1,261), reflecting a sharp contraction in this sector's activity. Employment also receded in manufacturing, trade and financial and insurance services. The public sector saw a rise in employment in administration and health and social care sectors, while employment figures in the education sector were trimmed down.

Data provided by the National Employment Service suggest that unemployment is on the decline for the second straight quarter – in Q3 it fell by 2.2%. Y-o-y, the fall in unemployment slowed down in September to 1.1%. Observed by group, the largest drop in unemployment in Q3 was registered in groups linked to manufacturing (machinery and metal processing, textile industry and leather production). The good agricultural season helped reduce unemployment in agriculture and food processing. On the other hand, unemployment rose in the health, pharmaceutical and social care sectors.

In Q3, the number of unemployment beneficiaries declined to 61,247 in September, down by 3,355 relative to June.

Amendments to the labour law should help improve the situation in the labour market. The announced amendments envisage simplified procedures to hire and fire, extension of fixed-term employment contracts from one to three years, introduction of new flexible forms of work (homeworking, job sharing) and a different manner of calculating severance pay (per year of service with the last employer). These changes seek to liberalise the labour market and reduce its rigidity, which will ultimately help increase employment.

Chart IV.5.3 **Employment figures and unemployment rate**



Source: SORS.

Q3 saw a further moderate decline in the number of formally employed.

6. International environment

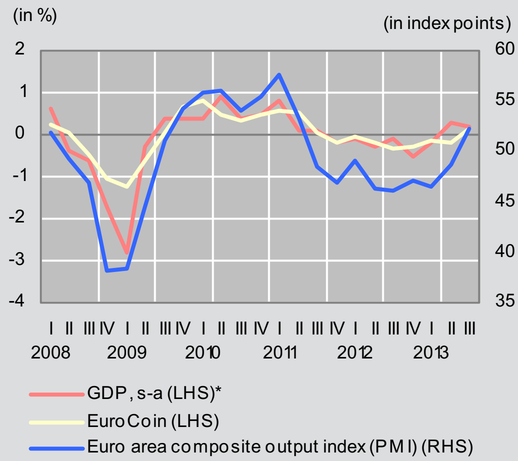
Euro area recession has ended, but recovery in the region remains tepid and uneven. Fed has temporarily delayed the decision on QE tapering. Weakening of inflationary pressures in the euro area and the region is continuing.

Economic activity

In Q2, **the euro area** saw a 0.3% GDP growth, ending six straight quarters of recession. However, it is early to speak of a vigorous revival given that growth is still uneven across countries. Nonetheless, the October Consensus Forecast revised the euro area's projected GDP drop in 2013 from 0.6% to 0.3% and slightly raised the GDP growth projection for 2014 from 0.8% to 0.9%. In its latest report, the IMF also came out with estimates of a lower GDP fall in the euro area in 2013 (-0.4%). Unemployment remains high (12.2% in September).

German economy continues to spearhead economic recovery in the euro area. Owing to a rise in personal consumption and a rebound in investment, Germany's GDP advanced 0.7% s-a in Q2. Positive movements are

Chart IV.6.1 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)

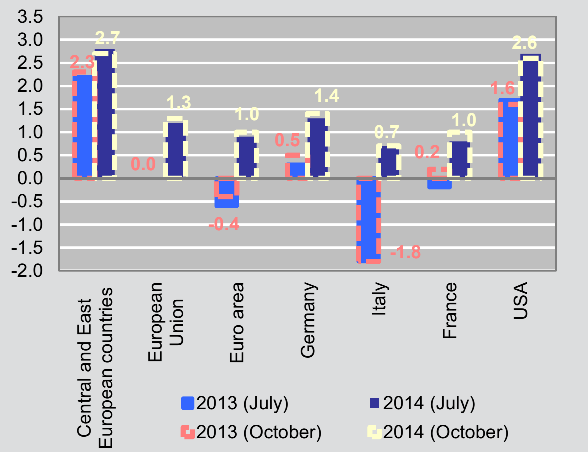


Sources: Eurostat, Markit Group and Banca d'Italia.

* Consensus Forecast estimate for Q3 2013.

Indicators show continuation of economic recovery of the euro area which started in Q2.

Chart IV.6.2 **Revisions of real GDP growth forecasts for 2013 and 2014 by the IMF***
(%)



Sources: IMF WEO Update (July 2013) and IMF WEO (Oct. 2013).

* Revision compared to July WEO Update.

In October, the IMF reduced its forecast of a decline in GDP for the euro area in 2013.

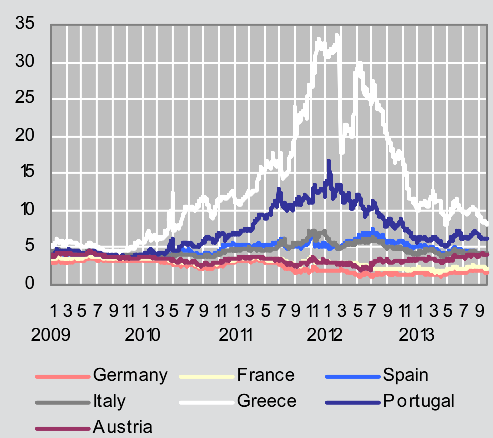
expected to continue in the coming period, as indicated by the September growth of PMI Composite, which hit an eight month high of 53.8 points. The increase in the consumer confidence index is expected to have a similar impact.

Euro area economy is likely to continue on the recovery path in Q3, bearing in mind that the PMI Composite has been in the expansion zone for four consecutive months. Nevertheless, risks are still present and a broader recovery will not be attained until peripheral economies exit the recession. Once this transpires, employment can also be expected to rise.

Growth prospects in **Central and East European** countries deteriorated slightly, despite signs of an upturn in the euro area. According to estimates, euro area recovery will reflect on economic growth in the region in 2014 at the earliest. Relative to July, the October Consensus Forecast scaled its 2013 regional growth projection down by 0.3 pp to 2.0% and its 2014 projection by 0.4 pp to 2.9%. The IMF forecast for 2013 was revised up by 0.2 pp to 2.3% and somewhat less for 2014, by 0.1 pp to 2.7%.

In Russia and Turkey, the two largest countries in Central and Eastern Europe, economic growth slowed down on account of dampened external demand and capital outflow, while Poland also had to face weak domestic demand. Hungary repaid its IMF loan from 2008 ahead of schedule, but is now grappling with deteriorated business

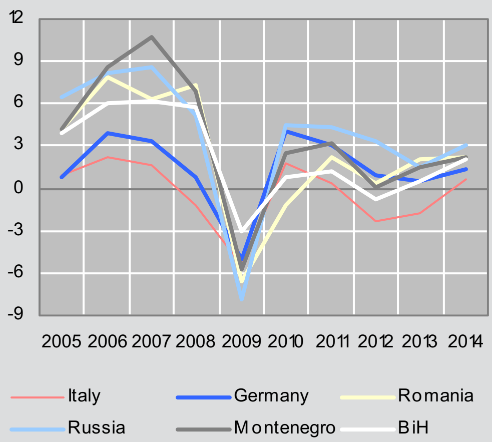
Chart IV.6.3 **Yield on 10-year bonds of euro area members**
(daily data, in %)



Source: Bloomberg.

Yields on government bonds of euro area countries declined on the back of Fed's decision to postpone the tapering of the quantitative easing programme.

Chart IV.6.4 **GDP movements of Serbia's key foreign trade partners**
(y-o-y, in %)



Source: IMF WEO (latest available data).

Economic growth forecasts were revised upward in Serbia's major foreign trade partners.

climate and undermined investor confidence. Negative growth in 2013 is still in store for Croatia and the Czech Republic, while Slovenia will remain in recession in the following year as well.

US economy picked up to 0.6% s-a in Q2, mostly on account of rising exports and investment, while a fall in government consumption acted in the opposite direction. Unemployment continued down in Q3, coming at 7.2% in September, yet new non-farm payroll employment stayed below August figures.

In October, the USA was in the focus of global economic developments as there was no political consensus over the 2014 budget and the public debt ceiling had been reached. The delay in budget adoption forced the government to furlough around 800,000 federal workers – a move that could drag down the country's nascent economic revival. The federal government temporarily suspended the debt ceiling[23], however the lack of a lasting solution could yet lead to further slowing of growth in the coming year.

Inflation movements

Inflationary pressures in the **euro area** loosened their grip significantly in Q3. Y-o-y inflation in September was 1.1%, considerably below the target (below, but close to 2%). Inflationary pressures eased mostly on account of lower prices of energy and low aggregate demand, induced by prolonged recession. Eurostat preliminary estimates indicate that October inflation slid even further, to 0.7% y-o-y.

Inflationary pressures continued to ease in **Central and East Europe** in Q3 due to weak aggregate demand and lower food prices. In most countries in the region, y-o-y inflation was below 2.0% in September while Bulgaria saw negative inflation from August.

After July inflation in the **USA** rose to 2.0% y-o-y, inflationary pressures lessened in August and September (1.2% y-o-y in September). Lower inflation was for the most part triggered by a fall in energy prices.

Monetary policy

Lower inflationary pressures in the euro area created a window for further ECB monetary policy relaxation. Hence, the policy rate was trimmed down in November by 25 bp to 0.25%. Top ECB officials announced that the rate will remain low for an extended period, i.e. until the economy begins to recover more vigorously.

The cycle of monetary policy easing continued in several countries in the region. The central banks of Hungary, Romania and Poland scaled down their policy rates in Q3 by 65 bp, 75 bp and 25 bp respectively. In October, the Hungarian central bank lowered its policy rate further by 20 bp.

Contrary to financial market expectations, in both September and October meetings, Fed decided not to taper government and mortgage-backed securities purchases, currently at a monthly pace of USD 85 bln. The main reason underlying such decision was the lack of credible data on sustainable economic recovery.

[23] Until 7 February 2014.

Financial and commodity markets

During most of Q3, the dollar exchange rate weakened against the euro – at end-September it depreciated 3.4% relative to end-June. This was largely due to positive macroeconomic indicators for the euro area in the three months to September, as well as the delay in the implementation of Fed's QE tapering programme. In response to the fiscal crisis in the USA, the dollar lost an additional 1.5% against the euro in October.

Closer to home, Croatia's credit rating was downgraded in Q3. In August, Standard & Poor's revised Croatia's outlook from stable to negative and in September Fitch lowered its credit rating from BBB- to BB+, sending Croatia among countries with a non-investment grade. Reasons for Fitch's decision include higher budget deficit, the anticipated public debt increase and a fall in GDP.

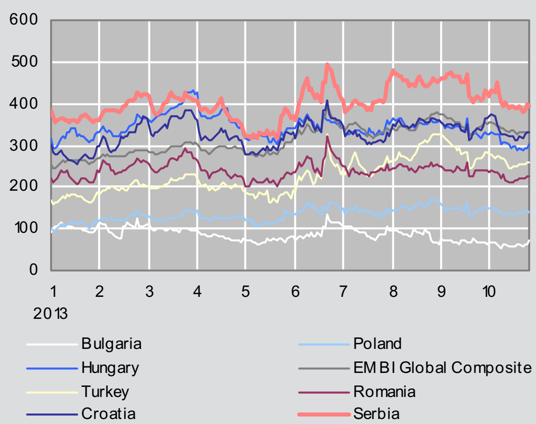
The price of gold rose by 7.8% in Q3, mostly on account of uncertainties regarding Fed's continued accommodative monetary policy, depreciation of the dollar and growing risk aversion of investors prompted by geopolitical tensions in the Middle East.

Text box 4: Impact of Fed's monetary policy on Serbia and other regional peers

Faced with the inability to cut nominal interest rates any further in an environment of the global economic crisis, some central banks, the Fed included, resorted to unconventional monetary policy tools. The Fed relied most on the purchase of government and mortgage-backed securities[1], i.e. quantitative easing, all with a view to spurring economic growth and bolstering employment. However, as the US economy started showing signs of recovery, around mid-2013 the Fed hinted at a possible reduction of the volume of asset purchases, which sent the financial markets in turmoil.

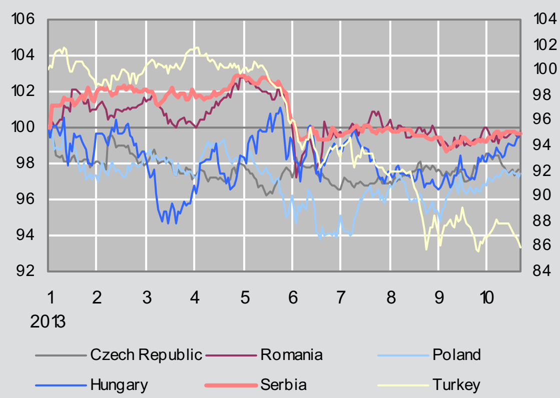
The first market reactions ensued after the Fed's chairman Ben Bernanke testified before the US Congress on 22 May and suggested gradual winding down of QE starting later in the year. Investors responded by increased risk aversion and by pulling out of riskier, but also higher-yielding markets in times of ample liquidity. The brunt of the Fed's hint was borne by emerging economies, Serbia included, whose currencies depreciated and risk premiums took off.

Chart O.4.1 **Risk premium indicator – EMBI by country**
(daily data, in bp)



Source: JP Morgan.

Chart O.4.2 **Movements in exchange rates of national currencies against the euro***
(daily data, 31 December 2012 = 100)



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

Depreciation was most pronounced in Turkey, its currency losing 7.3% from 22 May through 24 June, while less sharp episodes of depreciation were recorded in Romania (4.0%), Poland and Hungary (3.9% each). At the same time, the Serbian currency weakened by 3.3%. The strongest rise in risk premium of 179 bp (measured by EMBI) was recorded for Serbia, followed by Turkey (162 bp), Romania (121 bp) and Croatia (119 bp). All regional peers were also hit by an outflow of portfolio investments.

Still, Fed officials managed to soothe the financial markets in late June and in the course of July by tying QE to inflation and labour market developments. As a result, the risk premiums of countries in the region declined and their currencies stabilised. Relative to 24 June, end-July risk premium was lower by 49 bp for Romania, by 42 bp for Croatia and by 30 bp for Serbia, and all of them saw a mild strengthening in their currencies vis-à-vis the euro.

The financial markets of emerging economies were more peaceful in the course of August and September. Finally, on 18 September the Fed announced its decision to defer the start of QE tapering until the economy is strong enough to

[1] Monthly purchases of mortgage-backed and government securities currently stand at USD 40 bln and 45.0 bln, respectively.

generate self-sustained growth. This decision changed the financial markets' perception of the Fed's future policy action. The taper is now expected in the first half of 2014. This was also confirmed at the October meeting of the Fed's policymakers who agreed to keep the monthly volume of asset purchases unchanged. The change in market perception also helped calm the situation in the countries of the region, steadying their exchange rates further and causing in some instances a fall in risk premium.

In the first half of October, uncertainties in the financial market were stirred up by the Congress' inability to agree on a spending bill for 2014, leading to a government shutdown which left around 800,000 federal workers furloughed. This raises concerns over the shutdown's trickle-down effects and possible slowing of the economic recovery. Financial market stress was rekindled by the announcement that the US government had again reached the public debt ceiling. However, it eased as the policymakers adopted an interim budget to apply until 15 January 2014 and extended the debt ceiling until 7 February 2014.

Strong impact of the US monetary policy on global economic developments (manifested in May and June) was also noted by the IMF, which paid a great deal of attention in its October WEO[2] to the announced QE taper and its effect on emerging market economies. Namely, the IMF compared the current with the previous episodes of the US monetary tightening. The analysis revealed similarities with the 1994 episode. To be more precise, both episodes involved large capital inflows to emerging market economies prior to the event (monetary tightening), and sharp declines in equity prices and increases in long-term bond yields at the onset of the event. This had global consequences as it led to the widening of existing imbalances and recession in emerging market economies. Still, the IMF assesses that emerging market economies are now stronger and better prepared to weather a tightening in external financing because of the greater exchange rate flexibility and higher foreign exchange reserve buffers. Hence, the effects of the forthcoming shift in the Fed's monetary policy would create less volatility in emerging market economies than in mid-1990s.

[2] http://www.imf.org/external/pubs/ft/weo/2013/02/pdf/text.pdf, p. 36.

V. Inflation projection

Y-o-y inflation has returned within the target tolerance band in September and is expected to stay there in the period ahead. Low cost push-pressure in the production of food and weak aggregate demand will support its moving within the target tolerance band, while the VAT increase will generate some upward pressure. The risks to the projected inflation path are associated primarily with developments in the international environment, and to a certain degree, with fiscal movements at home.

After contracting in 2012, the Serbian economy is expected to grow around 2.0% in 2013 and around 1.5% in 2014. This year, growth will be led by net exports and in 2014 by investments as well.

The medium-term inflation projection aims to show the expected inflation movements (CPI), the main factors behind such movements and the underlying risks. It is expressed both as a range for the CPI and as a central projection rate. 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

Moving within the bounds of the short-term projection published in the August *Report*, y-o-y inflation recorded a sharp fall in Q3 and returned within the target tolerance band in September, measuring 4.9%. At quarterly level, consumer prices declined by 0.5%, driven chiefly by the seasonal drop in unprocessed food prices. What worked in the opposite direction were administered prices, notably those of electricity and cigarettes. On balance, administered prices have provided a significant contribution to inflation since the beginning of the year – of the total 2.5%, they accounted for around 75% (or 1.9 pp).

Domestic prices of primary agricultural commodities recorded a sharp decline in Q3 as a result of a very good agricultural performance this year. Thus, for instance, the price of wheat was lower in September by 26.1% than in June and that of corn by as much as 35.0%.[24]

Inflation decline was accompanied by a considerable drop in inflation expectations in all of the sectors surveyed. One-year ahead inflation expectations of the financial sector have returned within the target tolerance band – according to the October Ipsos and the November Bloomberg surveys they stand at 5.0%.

The exchange rate of the dinar against the euro was relatively stable in Q3, but for the depreciation episode from mid-August to mid-September. Depreciation pressures emerged primarily in response to non-residents' increased purchase of foreign exchange (payment of NIS dividends). They received additional impetus from global factors (anticipation of the Fed's decision on QE tapering) which affected the risk premiums[25] across the region, Serbia included. The unveiling of the Fed's decision to keep the volume of monthly asset purchases unchanged and of the Serbian Government's new economic measures reversed the trend, ushering in appreciation pressures in October. In order to ease excessive daily volatility of the exchange rate, the NBS intervened by selling a total of EUR 120.0 mln in Q3 and by buying a total of EUR 165.0 mln in October.

As a result of real depreciation of the dinar, the depreciation gap of the real exchange rate[26] reopened in Q3, indicating a moderate rise in net importers' marginal costs.

[24] Prices in the Novi Sad Commodity Exchange.

[25] Measured by EMBI.

[26] Real exchange rate trend is estimated by applying the Kalman filter.

In the year to September, consolidated budget deficit reached RSD 139.6 bln (5.2% of GDP). In early October, the Government presented a new set of economic policy measures which should produce savings to the state budget and ensure fiscal stability and economic growth. Among other things, these measures envisage a solidarity tax on public sector wages above RSD 60,000 net, revision of the special VAT rate from 8.0% to 10.0% (on staples), and to 20.0% (on IT equipment and hotel services), as well as restructuring of public enterprises and subsidy cuts. As estimated by the NBS, consolidated budget deficit this year will amount to 5.5% of GDP.

According to NBS estimates for Q3, GDP increased by 1.1% s-a and by 3.2% y-o-y. On the expenditure side, GDP growth was led by net exports, while domestic demand declined. As in the previous two quarters, export growth was due most to the automobile industry exports. On the production side, the largest positive contributions to GDP growth came from agriculture and industry, and the largest negative from construction.

Negative output gap[27] narrowed slightly in Q3, reflecting faster growth in NAVA relative to potential output (increase in the automobile and oil industry capacities). Despite slight narrowing, negative output gap indicates further demand-side disinflationary pressures in the medium run.

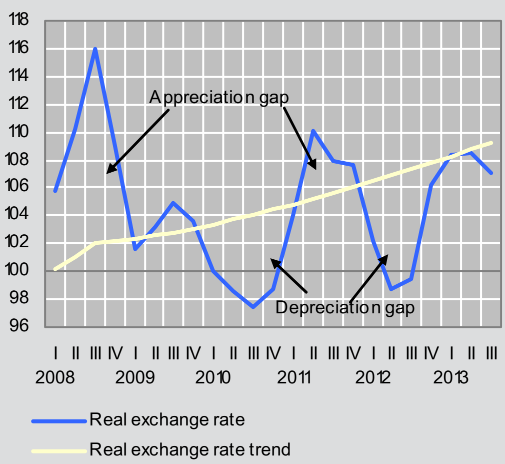
After six straight quarters of contraction, the euro area economy started its way out of recession rising by 0.3% s-a in Q2. PMI and Eurocoin readings for Q3 signal continuing recovery. After cutting the main refinancing rate to the historical low of 0.25% in November, the ECB reiterated a pledge to keep rates low for an extended period of time.

Projection assumptions

External assumptions

The assumption for the euro area's GDP growth in 2013 (-0.3%)[28] has been revised up by 0.3 pp relative to the August projection. The economic recovery, which started in Q2, is expected to gain ground, leading to 0.9% growth in 2014 and 1.3% growth in 2015. The recovery should be based on a gradual increase in domestic and external demand.

Chart V.0.1 **Real exchange rate and its trend***
(base index, Q1 2010 = 100)



Source: NBS.

* The estimate is based on the assessment of the impact of the real exchange rate on inflation.

The depreciation gap of the real exchange rate opened in Q3.

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

	2014		2015
External assumptions			
EU inflation (Q4 to Q4)	1.4%	(-0.1)	1.7%
ECB policy rate (year-end)	0.25%	(-0.25)	0.5%
Euro area GDP growth	0.9%	(+0.1)	1.3%
International prices of primary agricult. commodities (Q4 to Q4)*	15.0%	(+8.0)	4.0%
Brent oil price per barrel (year-end, USD)	109.0	(+1.0)	108.0
Internal assumptions			
Administered prices (Dec to Dec)	10.0%	(+1,0)	9.0%
Trends			
Appreciation trend of the real exchange rate (average)	2.1%	(+0.1)	2.2%
Real interest rate trend (average)	3.1%	(-0.2)	3.4%

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

[27] Output gap is calculated based on NAVA (GDP less agricultural production and net taxes). NAVA trend estimated by the Kalman filter is used as an approximation of the potential output.

[28] The assumption for the euro area's GDP growth in 2013 and 2014 is consistent with the latest Consensus Forecast.

According to the Eurostat's preliminary estimate, euro area inflation measured 0.7% y-o-y in October. At the same time, inflation expectations remain firmly anchored below, but close to, 2.0%. The current projection assumes that the ECB's main refinancing rate will be kept on hold throughout 2014 and that it will be raised by the end of 2015.

The movements of primary agricultural commodity prices internationally have a decisive impact on the movements of these prices locally. Though the current commodity futures herald a marginal rise in international primary commodity prices in 2014, the projection operates on a more conservative, experience-based assumption that these prices will increase to a somewhat larger degree (15.0%). As for 2015, the projection assumes that primary agricultural commodity prices will rise modestly, by 4.0%.

The end-2013 price of oil[29] is expected to be around USD 110.0 per barrel. Even though the current oil futures suggest a decline next year, the projection assumes oil price to stay close to the above level in 2014 and 2015.

Internal assumptions

The current medium-term inflation projection is based on the assumption that administered price growth in 2013 will be 10.8%. In the year to date, it came at 9.5%. Before the end of 2013, a certain increase is anticipated in the prices of utilities, social protection services, transport services (typical for Q4) and cigarettes. Early next year, administered price growth will be spurred by the VAT increase which we assume will take place in January.

The projection envisages that administered prices will grow faster than total CPI in 2014 and 2015 due to the gradual removal of price disparities (10.0% and 9.0%, respectively).

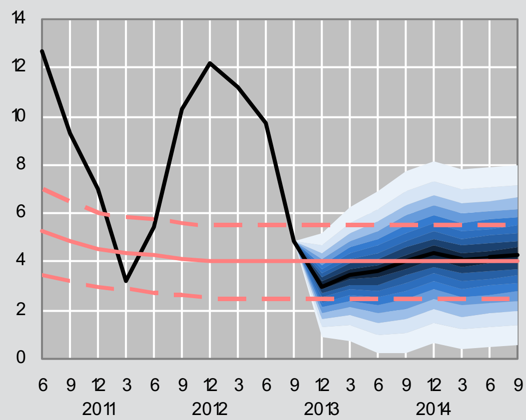
Inflation projection

Given the last year's high base[30], y-o-y inflation should fall to its minimum level in October (most likely undershooting the target tolerance band) and edge up closer to the target thereafter. By the end of this year and throughout the next, y-o-y inflation is expected to move within the target tolerance band (4±1.5%).

Looking ahead, the main disinflationary factors will be lower costs in the production of food and frail domestic demand. In addition, the inflation expectations' decline and convergence towards the target indicate that their inflationary effect is growing increasingly weaker.

Lower food production costs are expected chiefly on account of a further fall in primary agricultural commodity prices in Q3. This year's agricultural performance was much better than last year's, both at home and abroad, which led a sharp drop in prices of primary agricultural commodities. The consequent fall in the cost of raw materials in food production has already caused a decline in domestic processed food prices, and this decline is expected to gather pace over the coming period. The disinflationary effect of food prices should be sustained at least until the next agricultural season.

Chart V.0.2 **Inflation projection**
(y-o-y, in %)



Source: NBS.

Y-o-y inflation should be moving within the target tolerance band in the period ahead.

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%.

[29] The data on Ural oil not available, we now monitor Brent oil prices.

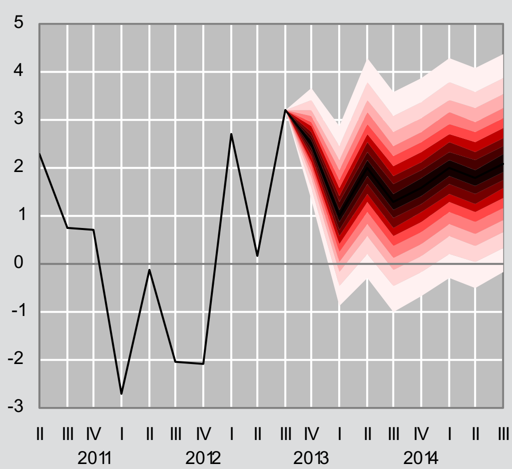
[30] In October 2012, monthly inflation measured 2.8%.

Low domestic demand continues to play the most important role in slowing price growth in the medium term. The disinflationary effect of domestic demand will be reinforced by the Government's new measures as they will bear down next year on both government and household consumption.

On the other hand, the expected upward revision of the special VAT rate from 8.0% to 10.0% or 20% in January 2014 will have a one-off effect on inflation. According to our estimates, the one-off effect of this revision on inflation will amount to 0.7 pp provided the prices of taxable products and services go up by the full amount of the VAT increase. The effect could of course be lower to the extent the VAT increase is absorbed, in an environment of low demand, by the cut in merchant margins.[31] The VAT increase will be retained in the y-o-y inflation rate over a one-year period following the increase.

The opening of the depreciation gap of the real exchange rate of the dinar in Q3 could send some upward pressure on inflation through the rise in import prices, but the intensity of this pressure will depend on the net importers' ability to command higher prices against the backdrop of depressed domestic demand.

Chart V.0.3 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

The Serbian economy is expected to grow around 2.0% in 2013 and around 1.5% in 2014.

Given the subsiding of inflationary pressures and assuming fiscal consolidation is implemented as planned, the Executive Board will consider further monetary policy easing in the coming period. However, as unexpected changes in the impact of some factors on the inflation projection remain possible, the above statement with regard to the character of monetary policy in the coming period is in no way binding on the NBS.

GDP should grow around 2.0% this year. On the production side, this growth will be powered by the rising agricultural output, while the strongest headwinds will be coming from the construction industry. On the expenditure side, growth will be led by net exports as all other components of domestic demand will record a decline.

GDP growth projection for 2014 has been revised down from the previous *Report* by 1.0 pp to around 1.5% on account of the expected implementation of fiscal consolidation measures. Growth will be propelled by net exports and investments, given the improved prospects for the euro area recovery, the start of EU membership negotiations and this year's low base. The contributions of government and household consumption to GDP growth will remain negative due to fiscal consolidation.

The risks to the GDP growth projection are balanced, i.e. deviations are equally possible in either direction. Uncertainties surrounding the projection relate mainly to the speed of economic recovery of the euro area, notably Serbia's main foreign trade partners, and to the intensity and pace of fiscal consolidation at home.

Risks to the projection

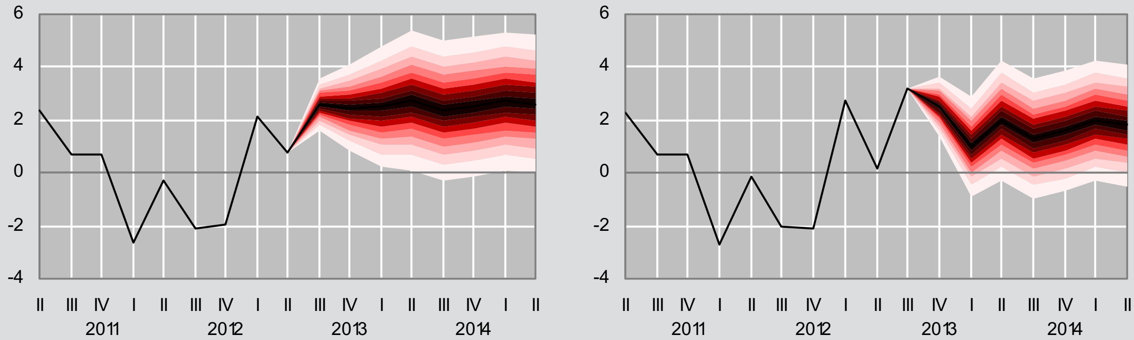
The risks to the projected inflation path are associated primarily with developments in the international environment, and to a certain degree, with fiscal movements at home.

Heightened uncertainties in the international environment stem primarily from the US economy. Once the Fed starts winding down its monetary stimulus, investors who entered emerging markets in search of higher yields will

[31] See Text box 2, p. 30.

Chart V.0.4 **Current vs. previous GDP growth projection**

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



Source: NBS.

GDP growth projection for 2014 has been revised down from August.

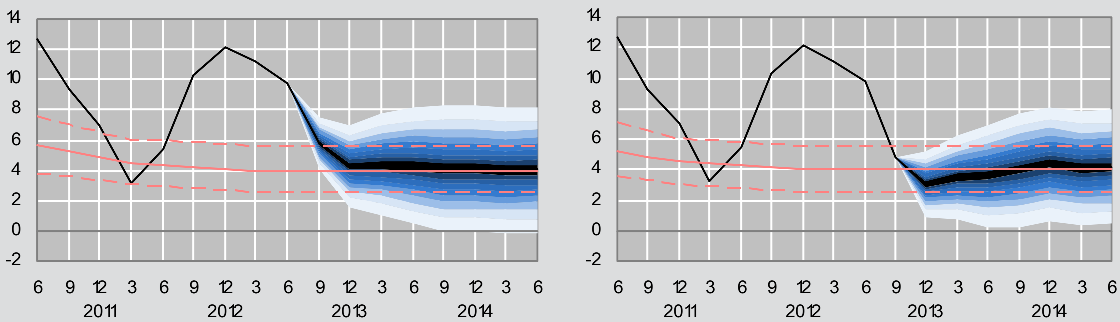
start pulling out. Only a hint at QE tapering in May was enough to cause a rise in risk premiums and capital outflows from emerging market economies, i.e. to send depreciation pressures on their currencies.[32] The start of tapering has been deferred for the time being. The extent to which its implementation will reflect on the financial markets of emerging economies will depend on the pace of the Fed's exit strategy. Another source of uncertainty regarding the US economy is whether the Congress will raise the debt ceiling in February 2014, because failure to do so could have significant negative implications for the global economy as a whole.

An unfavourable turn of events could push the risk premium higher and give rise to depreciation pressures, which would nudge inflation above the projected level. However, if unfavourable developments in the financial markets spill over to the real sector, aggregate demand would be kept subdued and would, as such, generate stronger disinflationary pressures in the medium term.

Chart V.0.5 **Current vs. previous inflation projection**

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

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



Source: NBS.

The new inflation projection for 2014 is lower than the August 2013 projection.

[32] See Text box 4, p. 40.

As for the risks stemming from the euro area, its slower recovery would probably strain Serbia's export opportunities and induce stronger disinflationary pressures from aggregate demand, whereas a faster-than-expected recovery would lead to opposite trends.

An unfavourable turn of events in the international environment could put developing countries, such as Serbia, under significant financial pressure. They therefore need to brace themselves, paying special attention to the strengthening of domestic macroeconomic fundamentals. In this context, the Serbian authorities must continue working on the reduction of internal imbalances, the fiscal imbalance in particular. Any departure from the announced fiscal consolidation plan could trigger a rise in inflationary pressures over the projection horizon. On the other hand, consistent implementation of the fiscal adjustment measures presented by the Government in October could ease the potential spill-over of the effects of monetary policies of some developed economies on the financial market at home.

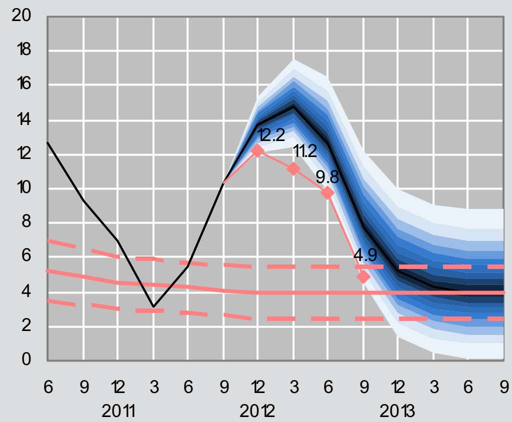
On balance, the risks to inflation projection are judged to be symmetrical.

Comparison with the previous projection

The projected spread of inflation outcomes in 2014 is lower than in the August *Report* and the medium-term projection band is slightly narrower. Lower inflation outturn is projected primarily on account of good agricultural performance, whose effects have reflected on food prices more than initially expected. The rise in electricity and gas prices also had a less indirect effect on inflation than anticipated earlier.

During the last twelve months, y-o-y inflation was moving along or below the lower edge of the band projected in November 2012 as food price growth turned out lower and the disinflationary effect of domestic demand stronger than expected at the time of the projection.

Chart V.0.6 **Achievement of November 2012 inflation projection**
(y-o-y rates, in %)



Source: NBS.

During the last twelve months, y-o-y inflation moved around or below the lower bound of the November 2012 projection band.

Table A

Indicators of Serbia's external position

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Q1 2013	Q2 2013	Q3 2013
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	9.5	8.2	8.7	7.6	8.2	7.4	7.0
Forex reserves/short-term debt	360.7	535.6	702.2	519.2	941.7	917.5	380.8	528.8	546.4	1,861.0	2,213.0	3,285.2	3,459.1	5,786.9
Forex reserves /GDP	13.6	16.4	16.4	24.3	38.5	33.8	24.9	36.6	35.8	38.3	36.5	38.8	34.3	32.6
Debt repayment/GDP	1.4	2.0	3.9	4.7	7.0	10.1	10.6	11.4	12.7	13.2	13.8	13.9	13.7	10.8
Debt repayment/exports of goods and services	7.0	9.0	16.4	17.7	23.5	33.2	34.0	38.9	35.2	36.3	34.7	35.1	30.6	22.7
EXTERNAL SOLVENCY INDICATORS (in %)														
External debt/GDP	58.7	55.9	49.8	60.1	60.9	60.2	64.6	77.7	84.9	76.7	85.9	87.6	83.8	80.3
Short-term debt/GDP	3.8	3.1	2.3	4.7	4.1	3.7	6.6	6.9	6.5	2.1	1.6	1.2	1.0	0.6
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	210.3	215.9	216.3	202.8	185.8
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	429.6	402.1	425.6	371.5	333.9
Forex reserves/reserve money	131.9	167.8	165.5	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	213.6	192.1	191.0
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	59.3	63.9	73.7	73.6	81.2	86.8	88.8	75.6	88.2	89.3	97.3	94.2	101.2	102.8
MEMORANDUM: (in EUR million)														
GDP	16,028	17,306	19,026	20,306	23,305	28,468	32,668	28,954	28,006	31,472	29,932	7,466	7,897	8,468 [1)]
External debt	9,402	9,678	9,466	12,196	14,182	17,139	21,088	22,487	23,786	24,125	25,721	26,722	26,072	25,686
External debt servicing	218	348	736	945	1,635	2,885	3,453	3,301	3,548	4,164	4,133	1,037	1,083	917
Central bank foreign exchange reserves	2,186	2,836	3,104	4,921	9,020	9,634	8,162	10,602	10,002	12,058	10,914	11,844	10,673	10,444
Short-term debt	606	529	442	948	958	1,050	2,143	2,005	1,830	648	493	361	309	180
Current account balance	-671	-1,347	-2,620	-1,778	-2,356	-5,053	-7,054	-1,910	-1,887	-2,870	-3,155	-627	-281	-121

		2004	2005		2006		2007	2008	2009	2010	2011	2012	2013
		Nov.	May	July	Feb.	Apr.	June	Dec.	Dec.	Nov.	Mar.	Aug.	July
CREDIT RATING	S&P	B+		BB-	BB-/positive		BB-/stable	BB-/negative	BB-/stable		BB /stable	BB-/negative	
	Fitch		BB-			BB-/stable		BB-/negative		BB-/stable		BB-/negative	
	Moody's												B1 /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 during that period.
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 (excluding early debt repayment to London Club creditors) to GDP during period under review.
Debt repayment/exports (in %) - ratio of debt repayment (excluding early debt repayment to London Club creditors) 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:

1. Data are subject to corrections in line with the official data sources.
2. As of October 2006, the IMF publication "International Financial Statistics" features a page on monetary statistics of the Republic of Serbia. This required the NBS to bring its statistical reports in compliance with international statistical standards and methodology harmonised, at the level of the IMF, for all countries. We have adjusted our financial risk exposure indicators accordingly.
3. Trade with Montenegro is registered within relevant transactions as of 2003.
4. Foreign debt repayment does not include: short-term debt repayment and advanced debt repayment.
5. In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.
6. As of 01.01.2010 the Statistical Office, according to UN recommendations, applies the general trade system which is a broader concept and includes all goods entering/exiting a country's economic territory,apart from goods in transit. The Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using the special trade system.
7. In September 2010, the methodology of external debt statistics was changed – public sector external debt includes liabilities under SDR allocation (EUR 443.7 mln) used in December 2009, as well as the capitalised interest to the Paris Club Creditors (EUR 24.8 mln). Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 863.1 mln, of which EUR 398.4 mln related to domestic banks and EUR 464.7 mln to domestic enterprises).

Table B
Key macroeconomic indicators

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Q1 2013	Q2 2013	Q3 2013
Real GDP growth (in %)[1]	4.3	2.5	9.3	5.4	3.6	5.4	3.8	-3.5	1.0	1.6	-1.7	2.7	0.2	3.2
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	7.0	12.2	11.2	9.8	4.9
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	12,058	10,914	11,844	10,673	10,444
Exports (in EUR million)[3)8)]	3,125	3,847	4,475	5,329	6,948	8,687	10,157	8,478	10,070	11,472	11,913	2,958	3,536	4,049
- 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	13.9	3.8	17.4	16.7	31.3
Imports (in EUR million)[3)8)]	-6,387	-7,206	-9,543	-9,612	-11,970	-16,016	-18,843	-13,404	-14,643	-16,627	-17,211	-4,077	-4,452	-4,655
- growth rate in % compared to a year earlier	27.2	12.8	32.4	0.7	24.5	33.8	17.6	-28.9	9.2	13.6	3.5	0.9	3.0	9.9
Current account balance[4)8)]														
(in EUR million)	-671	-1,347	-2,620	-1,778	-2,356	-5,053	-7,054	-1,910	-1,887	-2,870	-3,155	-627	-281	-121
as % of GDP	-4.2	-7.8	-13.8	-8.8	-10.1	-17.7	-21.6	-6.6	-6.7	-9.1	-10.5	-8.4	-3.6	-1.4
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	23.0	23.9		24.1	
Wages (average for the period, in EUR)	149.7	168.3	178.8	204.0	274.8	350.3	369.6	330.9	323.6	362.9	363.9	370.8	394.8	384.5
RS budget deficit/surplus (in % of GDP)[6]	-4.3	-2.4	-0.2	0.7	-1.7	-1.1	-1.9	-3.3	-3.5	-4.1	-5.7	-6.0	-5.4	-5.4
Consolidated fiscal result (in % of GDP)	-1.8	-2.4	0.8	1.1	-1.5	-1.9	-2.6	-4.5	-4.7	-4.9	-6.4	-4.6	-4.8	-6.1
RS public debt, (external + internal, in % of GDP)[6)7)]	72.9	66.9	55.3	52.2	37.7	31.5	29.2	34.7	44.5	48.2	59.3	62.5	61.1	60.5
RSD/USD exchange rate (average for the period)	64.29	57.56	58.45	66.87	67.03	58.39	55.76	67.47	77.91	73.34	88.12	84.61	85.90	86.20
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	80.87	86.18	87.43	87.41	84.89
RSD/EUR exchange rate (average for the period)	60.69	65.12	72.69	82.99	84.11	79.96	81.44	93.95	103.04	101.95	113.13	111.70	112.15	114.18
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	104.64	113.72	111.96	114.17	114.60
MEMORANDUM:														
GDP (in EUR million)	16,028	17,306	19,026	20,306	23,305	28,468	32,668	28,954	28,006	31,472	29,932	7,466	7,897	8,468 [9]

[1] At constant prices of previous year.

[2] Retail prices until 2006.

[3] Trade with Montenegro is registered within relevant transactions as of 2003.

[4] In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.

[5] Source: Labour Force Survey, Statistical Office.

[6] Source: MoF for public debt and NBS for estimated GDP.

[7] Government securities at nominal value.

[8] 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.

[9] NBS estimate.

Notes:

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

Appendix 1. National Bank of Serbia's Memorandum on Inflation Targets by 2016

National Bank of Serbia's Memorandum
on Inflation Targets by 2016[1]

To define the framework for medium-term monetary policy decision-making and to anchor and stabilise inflation expectations, the Executive Board of the National Bank of Serbia hereby sets the inflation target for the years 2015 and 2016.

In line with the *Agreement between the National Bank of Serbia and the Government of the Republic of Serbia on Inflation Targeting*[2] *and the Memorandum of the National Bank of Serbia on Monetary Strategy*[3], pursuant to which the National Bank of Serbia has committed to set inflation targets in cooperation with the Government, the Executive Board of the National Bank of Serbia hereby sets **the headline inflation target (with a tolerance band), measured as an annual percentage change in the consumer price index**, for the period December 2015–December 2016 at the level of 4% with a tolerance band of ±1.5 percentage points.

The inflation targets are set as point targets with a tolerance band. The inflation targets for 2013 and 2014 have not been changed from the levels determined earlier[4].

The National Bank of Serbia has set the inflation targets for 2015 and 2016 at the level of 4% with a tolerance band of ±1.5 percentage points.

The trajectory of targeted inflation reflects the intention to achieve price stability without causing any disruptions to macroeconomic processes. The inflation targets for 2015 and 2016 are set above the quantitative definition of price stability and the inflation targets of advanced economies (2.0% or 2.5%) due to the assessment that the process of structural reforms and the liberalisation of prices, i.e. nominal, real and structural convergence to the European Union, will not be completed by 2016.

It should be borne in mind that the inflation target is a medium-term objective, i.e. that the actual inflation may temporarily deviate from the target due to exogenous shocks. The National Bank of Serbia will allow temporary deviations from the target if bringing inflation back to the target in the short term warrants monetary changes that would cause additional disruptions to macroeconomic processes. This applies to sudden changes in primary commodity prices or to deviations of the planned growth in product prices under the Government's direct or indirect regulation.

In cooperation with the Government, the National Bank of Serbia may change the targets set for inflation. Such changes will be made in exceptional circumstances only and will be explained by the National Bank of Serbia.

[1] Adopted at the NBS Executive Board meeting of 18 October 2013.
[2] Adopted in Government session of 19 December 2008.
[3] Adopted at the NBS Monetary Policy Committee meeting of 22 December 2008.
[4] See the National Bank of Serbia's Memorandum on Setting Inflation Targets for the Period 2012–2014.

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Tables in boxes

Executive Board meetings and changes in the key policy rate

2012

Date	Key policy rate (p.a., in %)	Change (in basis points)
19 January	9.50	-25
9 February	9.50	0
8 March	9.50	0
12 April	9.50	0
10 May	9.50	0
7 June	10.00	+50
12 July	10.25	+25
9 August	10.50	+25
6 September	10.50	0
9 October	10.75	+25
8 November	10.95	+20
14 December	11.25	+30

2013

Date	Key policy rate (p.a, in %)	Change (in basis points)
17 January	11.50	+25
5 February	11.75	+25
12 March	11.75	0
11 April	11.75	0
14 May	11.25	-50
6 June	11.00	-25
11 July	11.00	0
8 August	11.00	0
10 September	11.00	0
18 October	10.50	-50
7 November	10.00	-50
12 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 10 September 2013

At today's meeting, the NBS Executive Board decided to keep the key policy rate unchanged at 11%.

The NBS Executive Board concluded that inflationary pressures have continued to subside on account of not only past monetary policy measures, but also largely due to reduced costs in food production as this year's agricultural season is much more favourable both globally and at home. The Executive Board confirmed once again its expectation that year-on-year inflation will return within the target tolerance band by October and stay within the band thereafter. The NBS's projection also includes the expected administered price growth in the remainder of the year.

The Executive Board positively assessed the continued economic recovery, which started in late 2012, as well as significant narrowing of the external imbalance resulting mainly from a sharper rise in exports of a growing number of industrial and agricultural products.

The Executive Board's decision to keep the key policy rate on hold was swayed by risks arising from the international environment, relating primarily to the developments in international financial and commodity markets. Furthermore, after the Fed hinted at possible tapering of its quantitative easing program, investor aversion went up in May and June, fuelling depreciation pressures in almost all countries of the region, Serbia included. An additional uncertainty is reflected in global oil price movements.

As assessed by the Executive Board, possible negative effects originating from the international environment could be largely offset over the period to come by consistent implementation of fiscal consolidation measures and structural reforms. This would positively affect Serbia's investor perception and contribute to the narrowing of internal and external imbalances, lower inflation and sustainable economic growth.

Press release from Executive Board meeting held on 18 October 2013

At its meeting today, the NBS Executive Board voted to cut the key policy rate by half a percentage point, to 10.5 percent.

Consistent with the National Bank of Serbia's expectations, y-o-y inflation has returned within the target tolerance band (4±1.5 percent), measuring 4.9 percent in September. The Executive Board judges that the key contribution to the inflation's return to the target came from monetary policy measures, the fall in primary agricultural commodity prices, relative stability of the dinar and low aggregate demand. Looking ahead, these factors will continue to moderate inflationary pressures and will help maintain inflation within the target band.

Inflation expectations have fallen to their lowest level on record and are expected to stabilise within the target tolerance band in the foreseeable future.

In its decision-making, the Executive Board was also guided by reduced risks associated with fiscal developments, following the announcement of fiscal adjustment measures. Low demand, together with the effects of fiscal consolidation measures, will serve as a strong disinflationary factor in the next year as well. Against such backdrop, the Executive Board assesses that the VAT increase, with its one-off impact, will generate weaker direct and indirect effects on inflation.

The Executive Board also expects positive trends in international financial markets as a result of the US budget deal.

The next rate-setting meeting of the NBS Executive Board will take place on 7 November 2013.

Press release from Executive Board meeting held on 7 November 2013

In its meeting today, the NBS Executive Board voted to cut the key policy rate by half a percentage point, to 10 percent.

As inflationary pressures and inflation expectations continue to subside, the Executive Board expects year-on-year inflation to fall close to the lower end of the target tolerance band in October. Inflation being already at a low level, future monetary policy measures will be geared at keeping it within the target tolerance band.

A decline in year-on-year inflation was prompted not only by monetary policy measures, but also by declining prices of primary agricultural commodities, low demand and relative stability of the exchange rate aided by highly favourable foreign trade trends. In the third quarter, the current account deficit amounted to only 1.4 percent of estimated GDP, against the background of increased economic activity. Moreover, the expected effects of fiscal consolidation and positive developments in international financial markets will contribute to the keeping of year-on-year inflation within the target tolerance band next year.

The next rate-setting meeting of the NBS Executive Board will be held on 12 December.

CIP - Каталогизација у публикацији
Народна библиотека Србије, Београд

336.71(497.11)

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

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