National Bank of Serbia

2014

November

INFLATION REPORT

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Introductory note

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

Since one of the underlying principles of inflation targeting is strengthening the transparency of monetary policy and improving the efficiency of communication with the public, the 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 13 November 2014.

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

Executive Board of the National Bank of Serbia:

Jorgovanka Tabaković, Governor

Ana Gligorijević, Vice Governor

Veselin Pješčić, Vice Governor

Diana Dragutinović, Vice Governor

Đorđe Jevtić, Director of the Administration for Supervision of Financial Institutions

ABBREVIATIONS

bln – billion
bp – basis point
CPI – Consumer Price Index
ECB – European Central Bank
EIB – European Investment Bank
EMBI – Emerging Markets Bond Index
FAO – UN Food and Agriculture Organization
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
LTROs – long-term refinancing operations
LHS – left hand scale
mln – million
NAVA – non-agricultural value added
NBS – National Bank of Serbia
NPLs – non-performing loans
OPEC – Organization of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
QE – quantitative easing
q-o-q – quarter-on-quarter
RHS – right hand scale
s-a – seasonally-adjusted
SDR – Special Drawing Right
SORS – Statistical Office of the Republic of Serbia
WTO – World Trade Organization
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Contents

I. Overview

Year-on-year inflation continued to move below the lower bound of the target tolerance band in the third quarter.

Year-on-year inflation continued to move below the lower bound of the target tolerance band in the third quarter, and was joined from August by core inflation as well. This shows that low inflationary pressures in the last year were not only a result of subdued cost-push pressure thanks to a good agricultural season globally and locally, but also a result of a fall in aggregate demand and weak pressures from import prices.

Uncertainties in the international capital market persisted in the third quarter.

Uncertainties in the international capital market, stemming from the Fed's QE tapering and geopolitical tensions over Ukraine, persisted in the third quarter. Though the end of the QE programme was expected, the timing and size of the Fed's policy rate increase remained uncertain. At the same time, strong disinflationary pressures in the euro area prompted the ECB to ease its monetary policy stance still further. As global economic activity recorded lower growth in the last two quarters than projected, growth prospects for this and the next year have been revised down, ushering in a drop in international prices of oil and primary agricultural commodities.

The dinar depreciated in the third quarter amid uncertainties in the international financial markets and unfavourable news regarding the sustainability of domestic public finances.

The above global factors dampened capital inflows and gave rise to depreciation pressures in emerging market economies, Serbia included. The pressures on the dinar were supported by unfavourable news regarding the sustainability of domestic public finances and the pace and scope of fiscal consolidation and structural reforms, as well as by increased energy imports and weaker export performance. Consistent with its practice so far, the National Bank of Serbia intervened in the interbank foreign exchange market in order to ease excessive short-term volatility of the exchange rate, without any intention to influence the exchange rate trend.

The risks in the local and international environment warrant caution in the conduct of monetary policy so as to stabilise inflation permanently at low levels.

Despite the strong disinflationary effect of low aggregate demand, the Executive Board of the National Bank of Serbia kept the key policy rate on hold from July to October, judging that the risks in the local and international environment warranted caution in the conduct of monetary policy.

Taking into account that the disinflationary effect of aggregate demand will be reinforced in the coming period by the cut in pensions and public sector wages and that the initiated implementation of fiscal consolidation and structural reforms will moderate the negative effect of uncertainties in the international environment, the Executive Board lowered the key policy rate in November to 8.0% and revised the FX reserve requirement ratios down.

The adopted fiscal policy measures are a positive step forward in terms of implementing fiscal consolidation and ensuring public finance sustainability.

Serbian authorities adopted the revised budget in late October, raising the general government deficit for this year by around RSD 40 bln. Even though consolidated budget deficit will be high in 2014 (around 7.5% of GDP), the adoption and consistent implementation of fiscal consolidation measures and structural reforms will have a positive bearing on foreign investors' perception of Serbia and the fall in the country risk premium, which will help increase the resilience of our economy to external risks. The expected agreement with the International Monetary Fund on a new arrangement will stand an additional assurance of the credibility of the Serbian economic policy.

The drop in economic activity proceeded in the third quarter.

The slowing growth of Serbia's key foreign trade partners and the negative effects of the May flooding continued to affect industrial production in the third quarter and perpetuated its fall. This accelerated the y-o-y drop in GDP to 3.7%. Based on our estimates, economic activity declined by 1.0% s-a from the previous quarter. The downturn in industrial production was driven mainly by the continuing slump in the sectors of mining and energy. Activity slackened also in manufacturing, notably as a consequence of halted production because of a collective annual vacation in the Fiat Automobiles Serbia and overhaul in the Pančevo refinery.

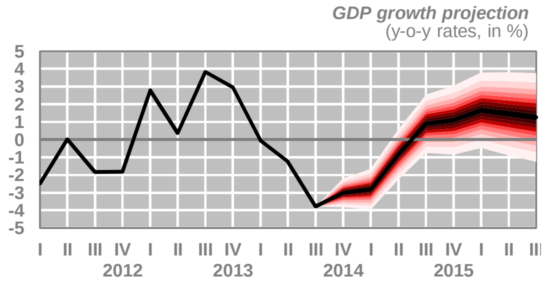
Based on the Labour Force Survey, movements in the labour market did not mirror the movements in the real sector.

By contrast to economic activity, the labour market showed an improvement relative to the previous quarters. According to the Labour Force Survey, the unemployment rate was cut to 17.6%, its lowest level since 2010. Employment increased thanks primarily to seasonal, occasional and fixed-term employment.

The reduction of external imbalances was temporarily halted due to the negative effects of the flooding and the softening of external demand.

The current account of the balance of payments deteriorated slightly from the previous quarter, in response to the widening of the foreign trade deficit due to the negative effects of the flooding, but also in response to the softening of external demand and lower inflow of remittances. Nevertheless, capital inflow in the third quarter was higher than in the previous two quarters and more than sufficient to finance the current account deficit. Having in mind the lower external demand, we expect that the share of the current account deficit in GDP this year will stay close to last year's level (around 6%), and that the reduction of external imbalances will continue in the years ahead.

GDP is expected to contract in both 2014 and 2015.



Due to the negative impact of the May flooding on the energy and mining sectors and the slowing growth of Serbia's key trade partners, our GDP will contract this year, and most probably next year as well having in mind additional fiscal consolidation measures.

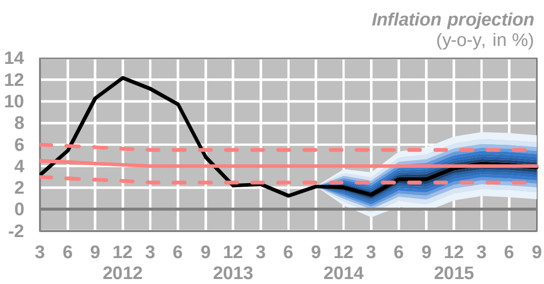
Due to the weakening of external demand and increased energy imports, the contribution of net exports in 2014 will be neutral.

Due to the weakening of external demand over the past several months and increased energy imports, the contribution of net exports to GDP in 2014 is estimated to be neutral, rather than positive as expected earlier. Negative contribution is anticipated from household consumption and private investment, while a positive contribution is expected from government investment.

In 2015, however, net exports are expected to provide the largest positive contribution to GDP, as a result of the recovery of the euro area and implementation of additional fiscal consolidation measures at home.

Final consumption is expected to be lower because of a cut in pensions and public sector wages, which will have a negative effect on economic activity next year, but represents a precondition for macroeconomic stability and sustainable economic growth. Net exports should provide a positive contribution, as a result of the euro area recovery, but also smaller imports against the backdrop of lower final consumption. Investments are expected to gather pace not only on the back of efforts to restore flood damage, but still more so owing to the improvement in the business and investment environment, which should lead to Serbia's better ranking on the global competitiveness list.

The November inflation projection is lower than the August projection as the fall in primary commodity prices over the past several months turned out sharper than expected and the adjustment of electricity prices failed to take place.



Year-on-year inflation will stay below the lower bound of the target in the current and the coming quarter, possibly re-entering the target tolerance band temporarily in November. The projected spread of inflation outcomes up to mid-2015 is lower than in the August projection because of the following factors with a temporary effect: the fall in primary commodity prices in the past six months and the absence of adjustment in electricity prices. Inflation's return within the target tolerance band is now expected around mid-2015. Until the end of that year, inflation is expected to trend closer to the 4% target and continue revolving around the target over the remainder of the forecast period. Inflation's rise to the target in 2015 will be driven primarily by administered prices, since their contribution to headline inflation is envisaged to match those in the previous years. The cost-push pressures in the production of food are likely to be rather low until the next agricultural season. However, once the agricultural season starts in the second half of the year, food prices may be reasonably expected to go up.

The character of monetary policy in the period ahead will depend on the effects of past monetary policy measures, fiscal consolidation and structural reforms, and developments in the international environment.

Looking ahead, monetary policy easing will depend on the effects of past monetary policy measures, the effects of fiscal consolidation and structural reforms, as well as on the assessment of the potential inflationary impact of developments in the international environment.

II. Monetary policy since the August *Report*

Following a cut to 8.5% in June, the key policy rate was kept on hold until November, when it was lowered to 8.0%.

In keeping the key policy rate on hold, the NBS Executive Board was mindful of uncertainties in the international environment (notably geopolitical tensions in Ukraine, protracted period of sluggish euro area growth and reduction of the Fed's monetary stimulus) and unfavourable fiscal developments at home. Because of these factors, despite the strong disinflationary effect of weak aggregate demand, caution was exercised in the conduct of monetary policy in order to stabilise inflation at low levels in the long run.

Taking into account that the disinflationary effect of aggregate demand will be reinforced in the coming period by the cut in pensions and public sector wages and that the initiated implementation of fiscal consolidation and structural reforms will moderate the negative effect of uncertainties in the international environment, the Executive Board lowered the key policy rate in November to 8.0% and revised the FX reserve requirement ratios down.

Following a cut in June, the key policy rate was kept at 8.5% until November due to uncertainties in the international and domestic environment and the possibility of their negative impact on economic developments in Serbia.

The Executive Board kept the key policy rate on hold bearing in mind the geopolitical tensions associated with the crisis in Ukraine and the risk of their escalation, which could negatively affect capital and energy flows and the pace of the euro area recovery and send prices in the international commodity markets into an upward spiral. It was assessed that the protracted period of sluggish euro area growth could have an adverse effect on domestic exports and economic activity because of our strong trade linkages with the euro area economies. Weaker external demand would probably lead to weaker export performance and to a slightly higher foreign trade deficit than expected.

Besides, uncertainties in the international capital market, triggered by the Fed's QE tapering, persisted. It was expected that the six-year effort to stimulate the US economy would end in late October and that the interest rates would be raised for the first time in H2 2015. The latter is believed to have a stronger potential to ruffle the markets than the former. On the other hand, even though the ECB increased its monetary accommodation, it seems that this has had no effect so far on the liquidity of euro area banks.

While external imbalances of Serbia have narrowed since the start of the crisis, a number of challenges remain. External debt of the private sector decreased, but that of the government soared due to heavy reliance on foreign sources of funding. The need for external sources of funding makes the economy vulnerable to changes in investor sentiment, i.e. negative shocks in capital inflows which could send pressures on the country risk premium and the exchange rate.

The effect of external factors, along with uncertainties over fiscal movements at home, made the Executive Board halt the process of monetary policy easing so as to stabilise inflation at low levels in the longer run. The level of the key policy rate was kept unchanged despite the strong disinflationary effect of low aggregate demand, which will be reinforced still further by the new fiscal consolidation measures. The country's unfavourable fiscal position is additionally aggravated by the need to restore flood damage. This, along with the postponing of the adoption of fiscal consolidation measures for the end of the year, increased the size of the necessary fiscal adjustment. The Executive Board used every opportunity to reiterate its expectation that the adoption and consistent implementation of fiscal consolidation measures and structural reforms will have a positive impact on foreign investors' perception of Serbia as an investment destination. This would contribute to the easing of the above external risks and would at the same time exert a positive effect on the country risk premium.

After reviewing current monetary and macroeconomic movements in the October meeting, the Executive Board stated that economic activity slowed down further due to the negative effects of the flooding, but also due to the slower-than-expected recovery of the euro area and Serbia's other key trade partners. The Board agreed that the GDP drop in 2014 would also be due to the anticipated additional fiscal consolidation measures, which would have a dampening effect on economic activity in the short term, but which nonetheless constitute a precondition for long-term sustainable economic growth.

To support credit, and thus economic activity, in its **November meeting** the Executive Board **lowered the FX reserve requirement ratios** by 1 pp across different maturities (from 29% and 22% to 28% and 21%) and raised the dinar share of FX required reserve allocations by 2 pp (from 32% and 24% to 34% and 26%).

In the same meeting, the Executive Board also decided to **trim the key policy rate by half a percentage point, to 8%**. In making this decision, the Executive Board was guided by the fact that y-o-y inflation has moved below the lower bound of the target tolerance band since March and that it is likely to remain there in the coming period given that the majority of factors will maintain their disinflationary impact.

The undershooting of the inflation target this year can be put down to factors with a temporary effect, notably the unexpectedly low growth in administered prices and international and local prices of primary commodities. The disinflationary pressures generated by factors with a lasting effect, such as aggregate demand, will be amplified still further by the cut in pensions and public sector wages.

The Executive Board expects that the initiated implementation of fiscal consolidation measures and structural reforms will moderate the negative impact of external factors stemming from uncertainties over monetary policy moves of the world's major economies. The Executive Board judges that the expected agreement with the IMF on a new arrangement will provide an additional assurance of the credibility of Serbia's economic policy.

As y-o-y inflation moved below the lower bound of the target tolerance band (4.0±1.5%) for six consecutive months, the **NBS sent an open letter to the government in September** in order to explain the reasons for the undershooting. The NBS stated that inflationary pressures weakened as a result of several factors, most of all the expectedly low aggregate demand, relatively stable movements in the foreign exchange market and reduced cost-push pressure on food prices. While the disinflationary effect of the first two factors was expected, the drop in food production costs was sharper than anticipated. The absence of adjustment of electricity prices in the last year also played a role in inflation undershooting. As for monetary policy action, the NBS noted that the key policy rate cuts which had started in May 2013 continued into 2014 (from 11.75% to 8.5%). Aware of the strong impact of geopolitical tensions on the country risk premium and the exchange rate, the NBS had to exercise caution in the conduct of monetary policy so as to stabilise inflation at a low level in the longer term.

III. Inflation movements

In the course of Q3, y-o-y headline inflation moved below the lower bound of the target tolerance band. As of August, core inflation has followed the same path. This implies that low inflationary pressures over the past year have been generated not only by reduced food production costs, but also by dented aggregate demand and subdued pressures arising from import prices. In Q4, y-o-y inflation is expected to hover around the lower bound of the target tolerance band. Low aggregate demand and the absence of electricity price adjustments will be the main factors delaying inflation's return to the target.

Stable one- and two-year ahead inflation expectations of the financial and corporate sectors, which have trended within the target band, indicate that stronger cost-push and demand-pull inflationary pressures are not likely in the coming period either.

Inflation movements in Q3

Consistent with expectations presented in the previous *Inflation Report*, y-o-y inflation moved below the lower bound of the target tolerance band throughout Q3 and arrived at 2.1% in September. As of August, core inflation has also trended below the lower bound of the target. This implies that low inflationary pressures have been generated not only by reduced food production costs in a solid agricultural season, both globally and at home, but also by dented aggregate demand and subdued pressures arising from import prices.

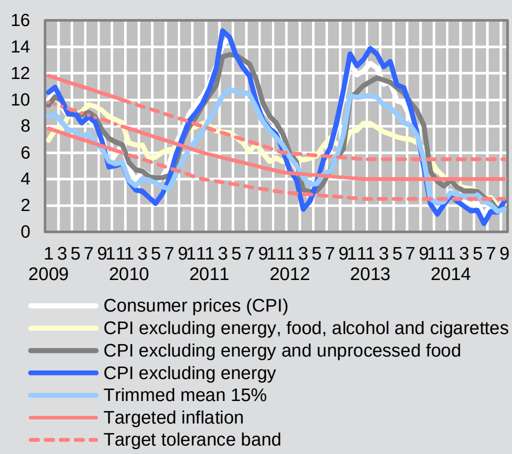
At the quarterly level, Q3 consumer prices rose 0.3%, slightly above our expectations, as the seasonally sharper drop in fruit and vegetable prices did not take place.

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

	2013		2014		
	III	IV	I	II	III
Consumer prices (CPI)	-0.5	-0.2	12	0.8	0.3
Unprocessed food	-13.4	-4.3	3.9	4.9	0.8
Processed food	-0.3	-0.7	0.6	-0.5	0.2
Industrial products excluding food and energy	2.0	10	16	-0.1	-0.3
Energy	5.1	-0.4	0.9	-0.4	10
Services	0.7	12	0.0	16	0.7
Core inflation indicators					
CPI excluding energy	-14	-0.2	13	0.9	0.2
CPI excluding energy and unprocessed food	10	0.5	0.8	0.3	0.1
CPI excluding energy, food, alcohol and cigarettes	0.7	10	-0.1	0.8	0.2
Administered prices	5.6	0.9	18	0.2	-0.6

Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

Headline and core inflation have moved below the lower bound of the target tolerance band.

Prices of **food and non-alcoholic beverages** went up in Q3, most notably in the **unprocessed food** category, contrary to our expectations. Unlike previous years, when fruit and vegetable prices would fall somewhat more steeply in Q3, fruit prices ratcheted up 18% this year, chiefly due to citrus shortages in Europe. Prices of fresh meat recorded a seasonal increase, though the rise in pork prices was partly due to rising global and domestic producer prices. Within **processed food**, an impetus came from higher prices of sunflower oil, milk and dairy products. In September, prices of food and non-alcoholic beverages edged up 1.6% y-o-y, giving a positive contribution to headline inflation after a year.

Prices of industrial products excluding food and energy lapsed back in Q3, mirroring low aggregate demand. Prices of clothes and footwear declined the most, while prices of passenger vehicles picked up. As we expected and given the shrinking trade volumes in the tobacco market, a rise in minimum excises did not translate into cigarette price hikes.

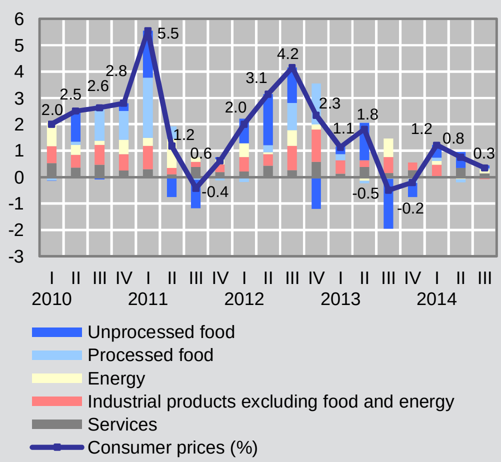
Growth in **energy prices** was prompted mainly by more expensive petroleum products. Despite a reduction in global oil prices, the dinar's weakening against the dollar pushed up domestic petroleum product prices by 1.7%.

Services prices were also a positive contributor, especially higher prices of compulsory automobile liability insurance, and to a lesser extent prices of apartment rentals, transportation and education services.

Core inflation (measured by CPI excluding the prices of energy, food, alcohol and cigarettes) displayed different dynamics during summer months. Growth was recorded in July, notably for compulsory automobile liability insurance, while August and September witnessed a downward revision. The August drop was due mainly to lower prices of landline telephone services, while the September decline was prompted by the seasonal cut in travel arrangement prices. As of August, y-o-y core inflation has moved below the lower bound of the target tolerance band.

For the first time since inflation has been measured by CPI, **administered prices** recorded a quarterly decline, predominantly on the back of falling prices of telephone services. A decline was also noted for prices of

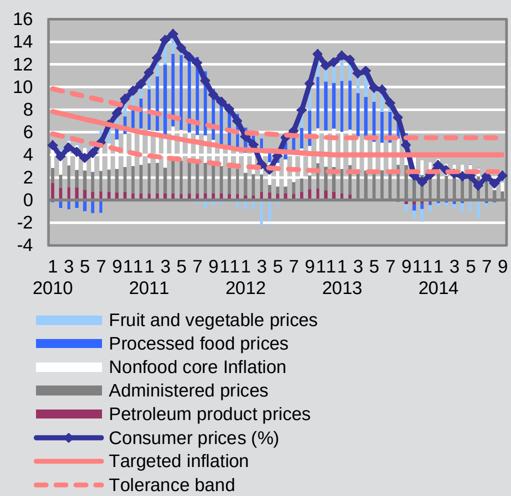
Chart III.0.2 **Contribution to quarterly consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

A positive contribution to inflation in Q3 originates from unprocessed food, which is not seasonally-induced.

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



Sources: SORS and NBS calculation.

After a year, the contribution of food prices to y-o-y inflation was positive in September.

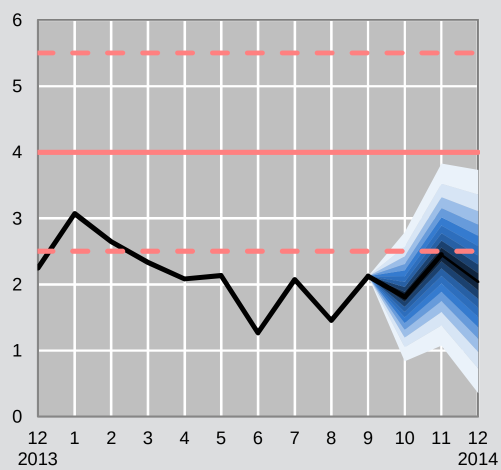
medicaments and TV subscription, which was abolished in August.[1] From early 2014, these prices added 2.6%, primarily because of adjustment to a higher VAT rate and excise increases. Y-o-y growth in administered prices slowed from one month to another, reaching 3.5% in September.

Expectations for Q4

In Q4, y-o-y inflation is expected to move around the lower band of the target tolerance band. The low base effect and dinar's weakening in Q3 will most probably be offset by dented demand and falling prices of primary agricultural commodities. Despite a higher q-o-q rise, y-o-y **core inflation** is likely to stay below the lower bound of the target in Q4 as well.

Prices are expected to decline in the category of food and non-alcoholic beverages, with unprocessed food providing a stronger negative contribution. Unprocessed food prices will decline, reflecting the seasonally lower prices of fresh meat, fruit and vegetables. Costs in processed food production will remain low in the coming period, as indicated by the fall in prices of primary agricultural commodities, set in train in mid-May and prevailing over the ensuing months, as well as a decline in agricultural futures prices and food producer prices in the domestic market.

Chart III.0.4 **Short-term inflation projection**
(y-o-y rates, in %)



Source: NBS.

Y-o-y inflation will move around the lower bound of the target tolerance band in Q4.

In contrast to the previous quarter, a positive contribution to Q4 inflation is expected from higher prices of **industrial products excluding food and energy**, on the back of dinar's depreciation in Q3.

Energy prices will lend a positive impetus to quarterly inflation in Q4, mostly due to the seasonal increase in solid fuel prices (coal and wood). Reflecting a steep drop in global oil prices, petroleum product prices are likely to decline in Q4. Contrary to our expectations from the previous *Report*, electricity prices will not increase by the year-end.

Growth in **services** prices is expected to overshoot the previous-quarter levels, most notably because of the seasonal rise in prices of travel arrangements.

Within **administered prices**, an upturn is likely for prices of heating and natural gas. However, none of these categories, observed individually, will provide any major contribution to CPI growth. At the annual level, administered prices will record much lower growth (around 3%) than projected in early year (9.5%), primarily due to the absence of electricity price adjustments this year.

The major risks to the projection concern fruit and vegetable prices, including the degree to which the Q3 depreciation will spill over to prices in an environment of low aggregate demand.

Producer and import prices

In Q3, **industrial producer prices for the domestic market** added 0.8%, whereas the y-o-y growth in September stayed flat at 1.0% from June. Producer prices went up in the exploitation of metal ores, purification and distribution of water, and some branches of manufacturing (production of motor vehicles and trailers, beverages, tobacco products, coke and petroleum products). Prices were lowered in the production of food products.

[1] As weights are changed once a year and as the TV subscription fee was abolished, until the year-end prices will be monitored for recreation and culture, including travel arrangements, where prices declined in the period observed.

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

	XII 2013 / XII 2012	III 2014 / III 2013	VI 2014 / VI 2013	IX 2014 / IX 2013
Consumer prices	2.2	2.3	1.3	2.1
Domestic industrial producer prices	0.8	0.2	1.0	1.0
Agricultural producer prices	-11.6	-6.1	-4,2	-0.1
Prices of elements and materials incorporated in construction	2.1	3.5	3.9	3.8

Sources: SORS and NBS calculation.

Agricultural producer prices[2] were pared back 3.7% in Q3, but stagnated in y-o-y terms. Relative to the previous quarter, prices of cereals, vegetables and industrial plants declined, whereas a rise was noted for fruit, potatoes and livestock. In the field of cattle breading, the strongest growth was observed for prices of poultry, live pigs and eggs.

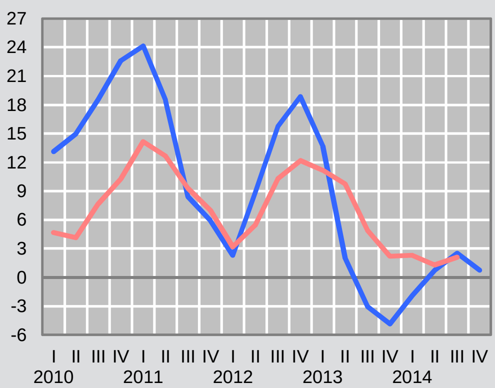
Cost-push pressures in the construction industry, approximated by the index of **prices of elements and materials incorporated in construction**, edged up 1.4% in Q3, close to the growth recorded in the quarter earlier. In y-o-y terms, these price remained broadly unchanged relative to Q2, reaching 3.8% in September.

As oil and food prices declined, **dinar-denominated import prices**[3] slowed their quarterly growth to 0.6% in Q3. The decline in import inflation was moderated by dinar's depreciation. Similarly to the previous quarter, import prices of intermediate and consumer goods stayed almost flat. A rise in import prices slowed in y-o-y terms as well (0.7% in September), lessening inflationary pressures in the domestic market.

Inflation expectations

For more than a year, one-year ahead inflation expectations of the financial sector have been stable and

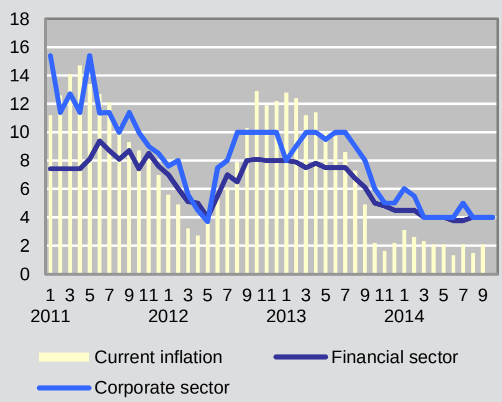
Chart III.0.5 **Domestic and imported inflation**
(y-o-y rates, in %)



Sources: Destatis, FAO, Bloomberg and NBS calculation.

A decline in global oil and food prices slowed down the y-o-y growth in import prices.

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



Sources: Gallup, Ipsos and NBS.

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

Inflation expectations of the financial and corporate sectors have stabilised within the target tolerance band.

[2] Producer prices in agricultural and fishing sectors.

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

within the target tolerance band. Corporate expectations are also stable, moving within the target band for almost a year. Inflation expectations have stabilised at a low level owing to low current inflation and subdued expected inflationary pressures.

According to the **Bloomberg** agency, **one-year ahead** expectations of the financial sector have flatlined at 4.5% since April 2014. As suggested by the **Ipsos** survey, one-year ahead financial and corporate sector expectations have stabilised at a somewhat lower level, standing at the midpoint since August (4.0%). Household expectations have been at a high 10.0% since April. It should be noted, however, that households believe that the previous-year inflation (perceived inflation) was also 10%, which is much above actual inflation. Qualitatively expressed inflation expectations of households show an increase in the number of respondents expecting prices to stay unchanged over the next year or expecting their moderate increase, compared to those respondents who expect significantly higher prices.

Medium-term, i.e. **two-year ahead** inflation expectations of financial and corporate sectors have moved within the target band, equalling 3.9% and 4.0% in October respectively. Medium-term expectations of the household sector have been at 10.0% since May.

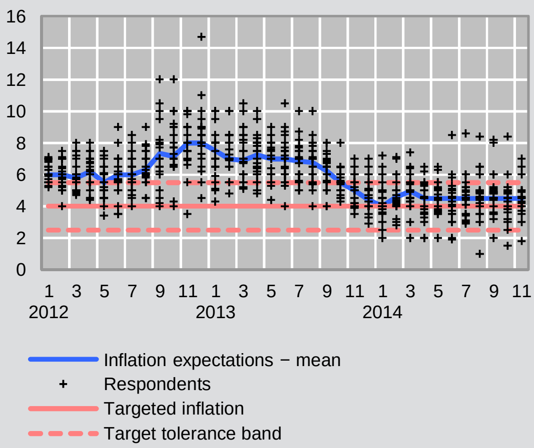
The dispersion of responses across sectors narrowed compared to the summer months, when it was high most

Table III.0.3 **Households' inflation expectations and perception**
(y-o-y rates, in %)

		Perceived inflation in previous year	One-year ahead expected inflation	Two-year ahead expected inflation
2014	March	10.0	8.0	8.0
	April	10.0	10.0	8.0
	May	10.0	10.0	10.0
	June	15.0	10.0	10.0
	July	10.0	10.0	10.0
	August	10.0	10.0	10.0
	Sept.	10.0	10.0	10.0
	Oct.	10.0	10.0	10.0

Source: Ipsos.

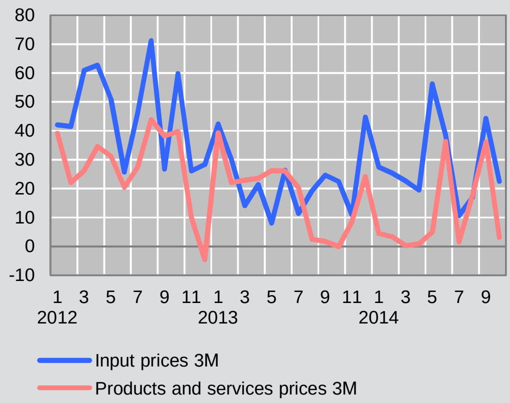
Chart III.0.7 **One-year ahead expected and targeted inflation – financial sector**
(y-o-y rates, in %)



Sources: Bloomberg and NBS.

The dispersion of financial sector expectations was somewhat smaller than during the summer months.

Chart III.0.8 **Expectations of enterprises regarding a change in prices of their inputs, products and services**
(net percentage, "+" = increase, "-" = decrease)



Sources: Ipsos and NBS.

Expectations of enterprises in terms of prices of their inputs and products and services have varied significantly since the year-start.

probably because of the uncertainties surrounding the effect of floods on inflation. Still, the dispersion was higher than in late 2013.

Following low levels recorded in July, August and September saw an increase in the net percentage[4] of enterprises expecting a rise in their input prices over the next three months, as well as those expecting a rise in prices of their products and services. The increase came about most probably because of the expected electricity price hike (which, however, did not take place). In October, a significant decline was noted in both categories, though the net percentage of enterprises expecting a rise in their input prices was higher than the net percentage of enterprises anticipating a rise in their product and services prices (22.5% vs. 3.1%).

[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.

IV. Inflation determinants

1. Financial market trends

Interest rates in the interbank money and government securities markets remained broadly unchanged in Q3. Depreciation pressures prevailed, fuelled by uncertainties in the international financial market and hints at impaired sustainability of the country's public finance.

Interest rates

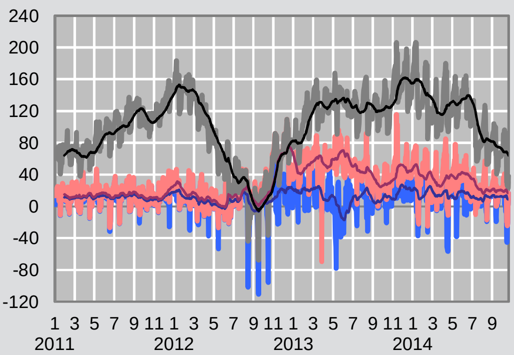
The average repo rate[5] rose a tad in Q3 (0.1 pp), reaching 6.5% by end-September.

The contraction in banks' excess liquidity sparked a gradual increase in trading volumes in the interbank overnight money market in Q3. Still, the average trading volumes in Q3 (RSD 2.1 bln) were insignificantly smaller than in Q2. BEONIA displayed minimum volatility in Q3 – a mild drop in July and a negligible rise in August and September. Thus, its average monthly value in September (6.4%) was almost unchanged relative to June.

BELIBOR rates followed a similar path. In September, they ranged from 6.7% for the shortest to 8.1% for the longest maturity on average, down between 0.2 pp and 0.4 pp from June.

Trading volumes in the overnight interbank market amplified in October, whilst interest rates stayed broadly flat.

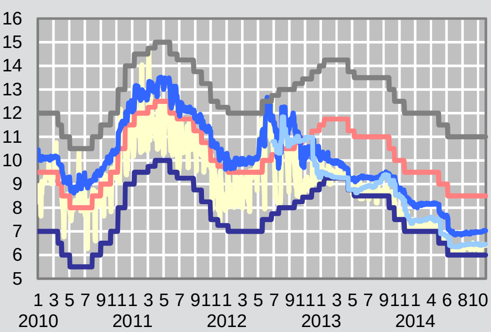
Chart IV.1.1 **Dinar liquidity**
(daily stock and moving averages, in RSD bln)



Source: NBS.

Banking sector liquidity was smaller in Q3, impacting on the gradual increase in trading in the interbank money market.

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



Sources: Thomson Reuters and NBS.

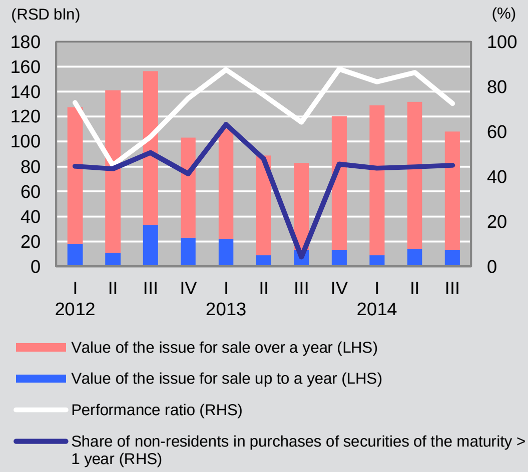
Interest rates in the overnight money market recorded minimal changes.

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

In the primary market of dinar government securities, a decline was noted only for the shortest-maturity rates, whereas rates on longer-maturity securities did not change relative to end-Q2. Rates (0.7 pp for three-month and 0.4 pp for six-month maturity) declined in the first half of Q3, when auction demand outstripped supply. However, since mid-August, demand narrowed. Movements in interest rates, including weaker performance at auctions, were partly determined by the government's reduced need to borrow in the domestic market – in light of access to external sources (the UAE loan) and a significantly smaller amount of securities maturing by the year-end (compared to H1). Thus, in September, interest rates in the market moved between 6.9% for three-month and 11.8% for seven-year maturity, whereas the weighted average rate stayed the same from June (9.7%).

Rates on euro-denominated securities changed insignificantly in Q3 – the rate for two-year securities went down 0.1 pp, whereas the rates for three- and five-year securities increased by the same amount. In late Q3, rates in this market segment ranged from 3.2% for one-year to 5.0% for five-year maturity.

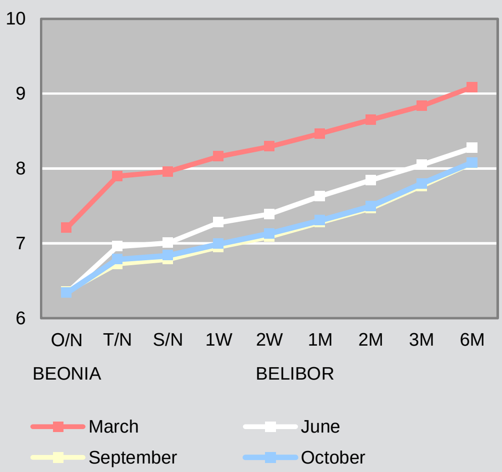
Chart IV.1.4 **Primary market of government dinar securities – performance ratio and foreign investor participation**



Source: Ministry of Finance.

The weaker performance at Q3 auctions was partly due to the government's reduced need to borrow in the dinar market.

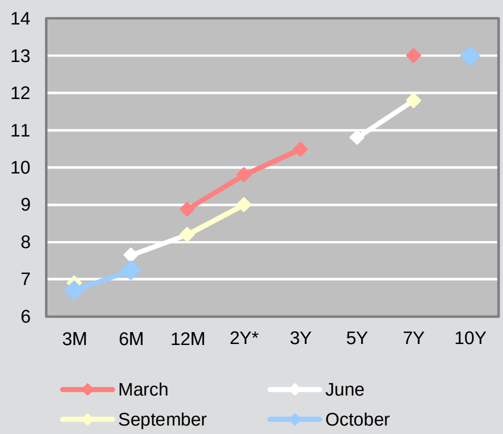
Chart IV.1.3 **Yield curve in the interbank money market in 2014**
(average values, p.a., in %)



Sources: Thomson Reuters and NBS.

Interest rates in the money market declined further relative to June.

Chart IV.1.5 **Interest rates in the primary market of government securities in 2014**
(p.a., in %)



Source: Ministry of Finance.

* Excluding coupon securities whose interest rate is linked to the NBS key policy rate.

The government borrowed in the domestic securities market under the same conditions as in late Q2.

Trading volumes in the secondary market of government securities increased further to RSD 91.8 bln in Q3, up by RSD 10.7 bln on Q2. A large portion of trading (RSD 53.7 bln) was performed up to two business days from the primary settlement date. Most traded were three- and one-year securities. The rates of return generally mirrored the primary market trends, moving by end-Q3 between 6.7% for the remaining two-week and 9.4% for 30-month maturity.[6]

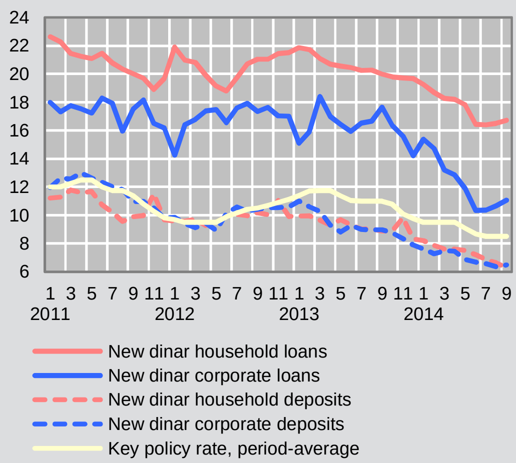
The dinar yield curve lengthened further in October when the government issued ten-year bonds, at the auction rate of 13.0%, only 0.3 pp above the rate achieved at the first auction of seven-year bonds one and a half years ago. Interest rates stayed broadly the same at other auctions held in October.

The weighted average rate on new dinar loans came at 13.8% in September, up by 1.6 pp relative to June. An increase was observed both for rates on corporate (by 0.7 pp to 11.1%) and household loans (by 0.3 pp to 16.7%). Still, the price of dinar corporate loans remained lower compared to the period before the launch of the government-support lending programme. At the same time, in the structure of total new dinar loans, the share of household loans went up (to 49% in September). As household loans were more expensive than corporate loans, the rise in the average rate exceeded the rise in rates on corporate or household loans observed separately.

The weighted average rate on dinar corporate loans picked up mainly due to the weaker disbursement of subsidised loans relative to the start of the programme, with the share of more expensive loans in new loans going up. The price of current assets loans was under the sway of subsidised lending[7], equalling 10.4% in September, which is insignificantly above the June figure (by 0.1 pp). The rates on other loans also went up (by 3.0 pp to 13.3%), while the rates on the least used, investment loans declined. A moderate rise in rates on dinar household loans was driven mainly by rising rates on cash and refinancing loans (by 0.2 pp), touching 16.6% in September. The price of consumer loans also increased.

Rates on new euro and dinar euro-indexed loans increased also relative to June (by 0.6 pp), arriving at 6.2% in September. Besides, the price of corporate went up to 5.9% and household loans to 7.4%. The largest increase

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

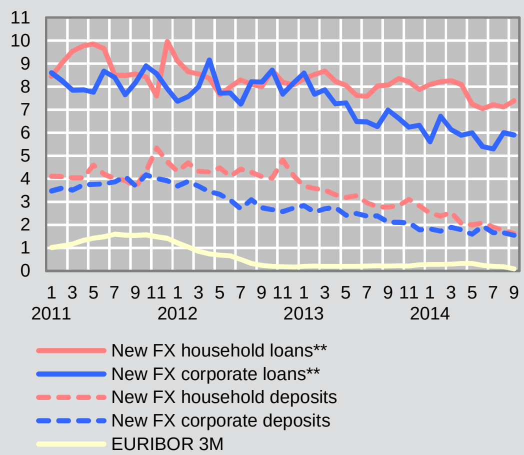


Source: NBS.

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

While deposit interest rates continued down, lending rates increased somewhat in Q3, both for dinars...

Chart IV.1.7 **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.

... and euros.

[6] Excluding the rate on seven-year securities (11.8%), which was equal to the rate in primary trading in these securities.

[7] The rate on these loans is capped to 5.45%, with the government subsidy of 5%.

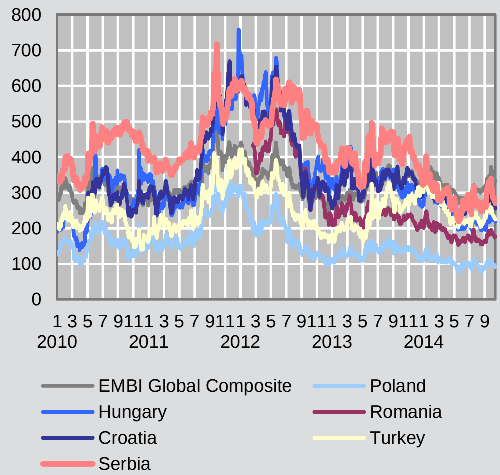
was observed for current assets and investment loans – to 6.3% and 5.7% respectively. Within the category of household loans, rates on FX-indexed housing and consumer loans were up 0.1 pp and 0.8 pp respectively, whereas the rate on other loans was down 0.8 pp. At end-Q3, rates on housing, consumer and other loans equalled 4.8%, 6.5% and 10.1% respectively.

A decline in deposit rates continued into Q3, resulting in the reduction of costs of bank funding sources. Weighted average rates on new deposits recorded the lowest values since September 2010 when the current interest rate statistics came into force.

The sharpest drop was recorded for the weighted average rate on new dinar household deposits (by 0.9 pp to 6.3% in September), while the rate on dinar corporate deposits fell somewhat less (by 0.2 pp to 6.5%). The interest rate on euro household deposits declined to 1.6% in September, to the level of the average rate on corporate deposits.

In anticipation of the World Savings Day, the NBS appealed with banks this year as well to try to win clients over and increase savings by offering improved terms and a wider range of products, while at the same time striving not to overstep the level of interest rates offered in the course of the year. As a similar appeal put forward last year was well-received by banks, no significant increases in interest rates are expected around this year's World Savings Day.

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



Source: JP Morgan.

Risk premia of countries in the region increased mildly relative to end-Q2.

Risk premium

Measured by EMBI, risk premia were relatively stable across the region, during the major part of Q3. EMBI rose temporarily in late July and early August, only to reverse to earlier levels thereafter. New growth ensued by end-September. Such trends were largely shaped by expectations about the "normalisation" of Fed's monetary policy (conclusion of the quantitative easing programme and an increase in Fed's interest rates), the positive news about the USA's macroeconomic indicators, and unfavourable indicators about the euro area recovery.

End-of-period, the strongest Q3 growth was recorded for risk premia of Turkey (33 bp) and Serbia. In terms of period-average, risk premia declined across the region, most notably in Hungary (21 bp). It was only Serbia's risk premium that increased negligibly (1 bp).

By end-Q3, EMBI for Serbia was 300 bp, up by 32 bp from end-June. In addition to global factors, Serbia's risk premium was affected also by negative assessments as to the pace and intensity of fiscal consolidation.

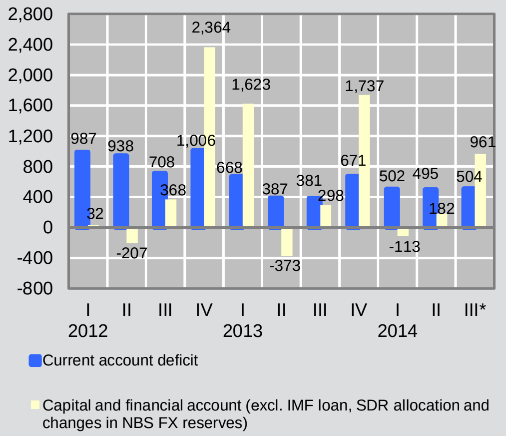
In early October, Standard & Poor's put Serbia's rating on negative watch until it is seen what fiscal consolidation measures will be adopted. The decision on a potential change in Serbia's rating (BB- with a negative outlook) will be made in early 2015.

Since mid-October, risk premia of all countries in the region have been on a decline. The downturn was the most pronounced for Serbia, whose risk premium measured by EMBI reached 270 bp in late October.

Foreign capital inflow

Q3 saw somewhat more unfavourable movements in the current account balance relative to Q2. This was due to the widening of the foreign trade deficit as a consequence

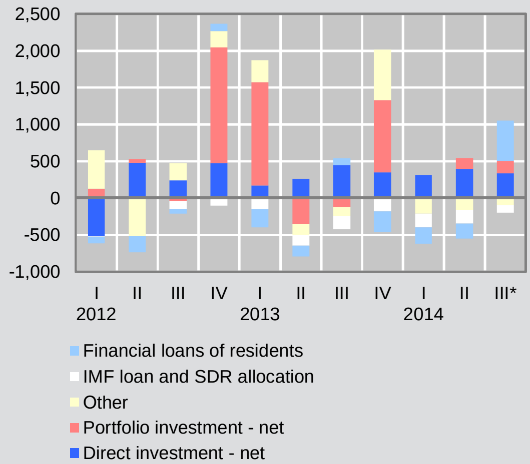
Chart IV.1.9 **Current account deficit and net capital inflow**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

Dented external demand and smaller remittances inflows brought about imperceptible worsening in the current account deficit in Q3...

Chart IV.1.10 **Structure of the financial account**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

... whereas capital inflows increased, mostly on the back of government borrowing.

of the adverse effects of floods, but also the slowdown in external demand and a contracted inflow of remittances (EUR 618.1 mln). However, the capital inflow recorded in the period observed exceeded the levels of the previous two quarters and was more than sufficient to cover the current account deficit.

Inflows in the financial account in Q3 concerned primarily government borrowing in respect of financial loans. Credit liabilities of enterprises went up, while banks continued to pay down their debts. FX inflows from FDIs were somewhat higher, while the level of non-resident investment in government securities was similar to the Q2 figure.

Net FDI inflows amounted to EUR 333.7 mln in Q3. In terms of structure, the largest portion of FDIs in Q3 concerned investments in equity (EUR 150.2 mln), followed by reinvested earnings (EUR 106.3 mln) and intercompany debt (EUR 77.2 mln)[8]. At the same time, dividends were paid out to owners abroad and interest was paid on intercompany debt, in the amount of EUR 86.6 mln and EUR 22.2 mln net respectively.

Since early 2014, FDIs accounted for a net inflow of EUR 1,044.6 mln and were channelled mainly to enterprises operational in trade, manufacturing and the financial sector. The net FDI inflow is estimated to reach EUR 1.25 bln at the year-level.

In Q3, foreign investors continued to invest in government securities, to a similar degree as in Q2. Together with the net inflow of EUR 169.5 mln in Q3, **portfolio investments** accounted for EUR 315.2 mln since the start of the year. Interest paid in respect of portfolio investment totalled EUR 97.4 mln in Q3, or EUR 295.1 mln since early 2014.

In Q3, residents borrowed externally **financial loans** worth EUR 448.8 mln net. The dominant part of borrowing concerned the UAE loan (USD 1.0 bln) for budget purposes. Moreover, tranches of several loans of the Development Bank of the Council of Europe, EIB and EBRD were also drawn. Together with payments for liabilities due (EUR 158.1 mln), net government debt in respect of financial loans rose by EUR 673.8 mln. To settle liabilities due, the NBS paid EUR 100.3 mln, of which the major part (EUR 96.6 mln) went into debt servicing obligations to the IMF. Thus, since the year-start, liabilities worth EUR 468.6 mln were settled towards this institution. Banks continued to pay down

[8] According to the IMF's BPM6, reinvested earnings and intercompany debt are included within FDIs. This change is explained in more detail in Text box 1 of the August 2014 *Inflation Report*.

their external debt (EUR 192.2 mln), which is twice the amount paid in Q2. In contrast to banks, cross-border borrowing by enterprises went up EUR 67.6 mln net.

Conversely, external liabilities of enterprises in regard to trade loans fell EUR 138.2 mln net.

Trends in the FX market and exchange rate

In Q3, the dinar lost 2.6% against the euro end-of period, or 1.5% in average terms. At end-September, the dinar was 9.4% weaker against the dollar compared to end-June, chiefly due to euro's depreciation against the dollar.

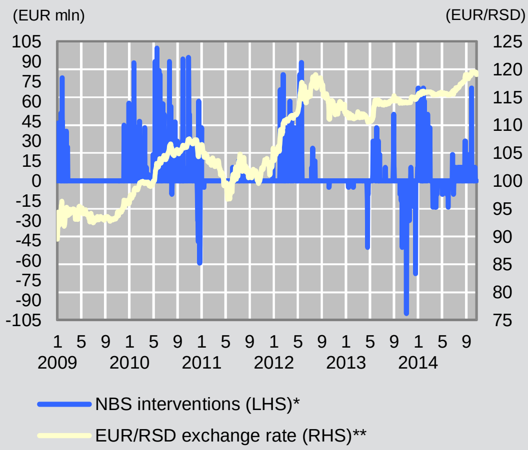
Depreciation pressures gathered pace in Q3 because of uncertainties in the international financial market over the heightened geopolitical tensions, most notably in relation to the Ukrainian crisis, a further reduction in the Fed's monetary stimulus, sluggish recovery of the euro area, and uncertainties as to the effects of ECB measures. Besides, the unfavourable news regarding the sustainability of Serbia's public finance and the pace and intensity of fiscal consolidation and structural reforms, reflected on modest capital inflows in Q3. At the same time, non-residents were again net FX buyers in the domestic market. In addition, the remittances inflow ran below the Q2-leves, while banks increased their external debt paydowns. Elevated FX demand of enterprises was due primarily to increased energy imports. Moreover, as economic growth of our most important foreign trade partners slowed down, Serbia's export performance weakened, as well as the related FX infow.

Following the record low values in Q2, trading in the IFEM recovered somewhat in Q3. Average daily trading volumes (excluding the NBS) amounted to EUR 24.8 mln in Q3, up by EUR 7.1 mln on the quarter before. Exchange rate volatility, measured by EWMA[9] and EGARCH[10], was consistent with trading volumes, which remained low despite the upturn recorded in Q3.

Apart from early July, when it bought EUR 10.0 mln, the NBS intervened in the IFEM selling EUR 235.0 mln in Q3. Consistent with its practice to date, NBS interventions aimed at easing excessive short-term volatility of the exchange rate, without intending to impact the exchange rate trend.

The NBS continued to organise three-month and two-week FX swap auctions. At three-month auctions, it sold

Chart IV.1.11 **Movements in EUR/RSD exchange rate and NBS FX interventions**

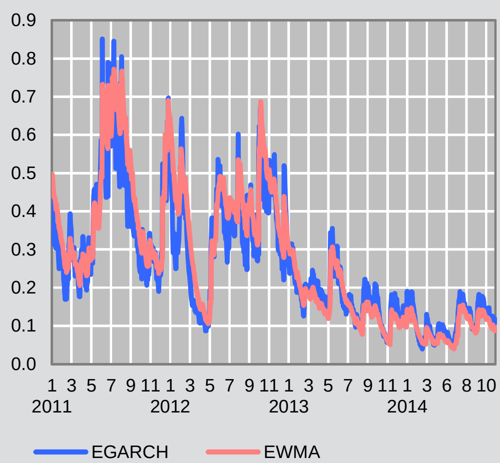


Source: NBS.

* + sale; - purchase.
** 1 EUR in RSD.

The NBS intervened in Q3 mostly by selling foreign currency in the IFEM.

Chart IV.1.12 **Short-term volatility of the RSD/EUR exchange rate**
(in %)



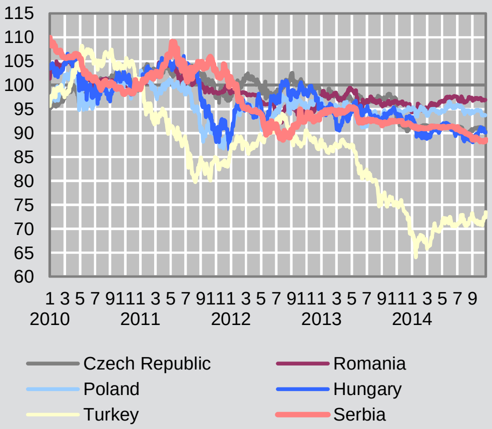
Source: NBS.

Although more pronounced in Q3, the volatility of the dinar exchange rate remained at a low level.

[9] EWMA – Exponentially Weighted Moving Average.

[10] EGARCH – Exponential General Autoregressive Conditional Heteroskedastic.

Chart IV.1.13 **Movements in exchange rates of national currencies against the euro***
(daily data, December 31, 2010 = 100)

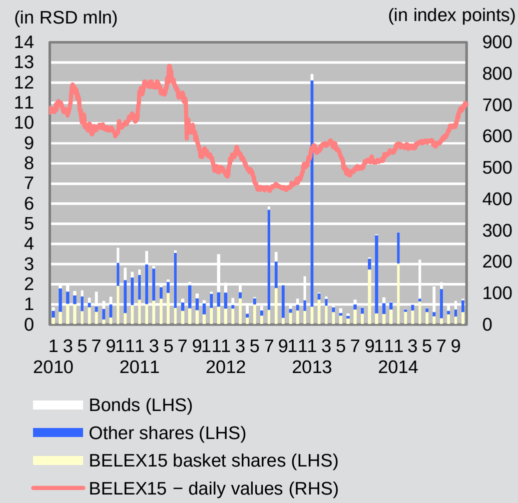


Sources: NBS and websites of central banks.

* Growth indicates appreciation.

In Q3, the dinar recorded somewhat greater depreciation compared to currencies of the region.

Chart IV.1.14 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

BSE indices were on a rise in Q3.

EUR 13.0 mln and purchased an equal amount, and at two-week auctions it both sold and purchased EUR 52.0 mln.

Mild weakening of the dinar continued until late October. In October, the NBS sold EUR 140.0 mln in the IFEM.

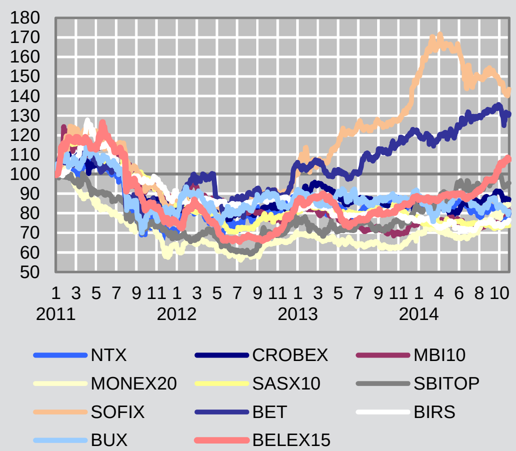
The heightening of geopolitical tensions and Fed's monetary tightening fuelled depreciation pressures also in other countries of the region running similar exchange rate regimes. Relative to end-Q2, of the currencies observed, the Romanian lei weakened the most (0.6%), followed by the Polish zloty (0.3%), Czech korona (0.1%) and Hungarian forint (0.1%). Only the Turkish lira remained stable.

Stock exchange trends

As stock prices went up on the Belgrade Stock Exchange (BSE) in Q3, indices recorded growth which was among the highest in the region. In late September, BELEX15 and BELEXline stood at 661.4 and 1,319.3 points respectively, up by 16.1% and 16.5% from end-June. BSE indices continued up in October, touching their highest values since July 2011.

Total trading in BSE shares amounted to RSD 3.2 bln in Q3, up by RSD 0.5 bln from Q2. The highest value was

Chart IV.1.15 **Stock exchange indices across the region**
(in index points, normalised, December 31, 2010 = 100)



Sources: BSE and regional stock exchanges.

The growth in BSE indices was among the highest in the region.

recorded in July (RSD 1.8 bln), on the back of trading in the open market.

The foreign investors' share in total stock trading contracted from Q2, equalling 29.1% on average. Still, they remained net buyers of shares of domestic issuers in Q3, due to purchases effected in September.

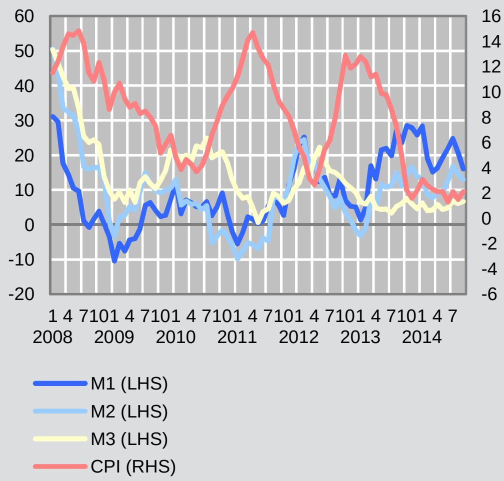
In contrast to shares, trading in frozen FX savings bonds was weaker than in Q2. Total trading came at RSD 1.0 bln in Q3, most notably in respect of bonds maturing next year. The rates of return for this series were on a decline, reaching 2.8% in late September. At end-Q3, the rates of return for the A2016-series rose to 4.1%.

Corporate bonds were not traded on the BSE in Q3 either.

BSE capitalisation went up RSD 34.6 bln to RSD 777.2 bln in late September. Regulated market capitalisation rose RSD 35.1 bln to RSD 437.4 bln, whereas the MTP[11] capitalisation contracted by RSD 0.5 bln to RSD 339.7 bln. As a result, the share of market capitalisation in estimated GDP[12] was up 0.9 pp to 19.9% in late Q3.

Indices picked up on the majority of regional stock exchanges, most notably in Podgorica (17.2%). In contrast, the sharpest reductions were seen in Budapest (3.9%), whereas the Sofia index continued down (2.1%).

Chart IV.2.1 **Monetary aggregates and CPI**
(y-o-y rates, in %)



Sources: SORS and NBS.

Y-o-y growth in money supply has been on a slowdown since August.

2. Money and loans

Though still high, y-o-y growth in monetary aggregates has been on a slowdown since August. This is partly due to subsidised loans which have also ensured a further pick-up in lending.

Monetary aggregates

Dinar reserve money increased both in quarterly and y-o-y terms, reflecting primarily on the growth in total reserve money.

In the course of Q3, banks reduced their investment in repo securities by RSD 50.0 bln, which, coupled with FX payment operations with Kosovo and Metohija (RSD 11.8 bln), exerted the strongest impact on the creation of dinar reserve money in Q3. A small portion of liquidity was created also from the monetisation of government FX deposits. However, under the impact of rising balances in dinar accounts, the government engaged in liquidity absorption (RSD 20.5 bln). Higher balances in the government's dinar account were determined by more intensive collection of tax revenue in July – VAT, excises

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

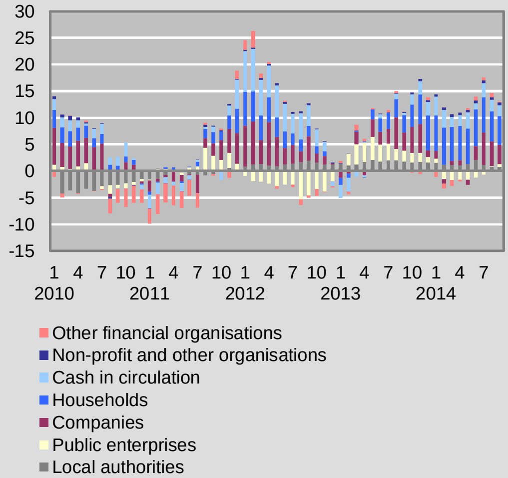
	2013	2014			Share in M3 Sept. 2014 (%)
	Dec.	March	June	Sept.	
M3	2.3	1.9	3.5	4.4	100.0
FX deposits	-1.5	0.4	0.2	1.7	67.7
M2	11.5	5.4	11.3	10.7	32.3
Time and savings dinar deposits	-9.4	-7.9	-6.8	4.1	9.4
M1	23.1	12.6	20.4	13.7	22.9
Demand deposit	31.3	15.7	28.5	16.6	16.1
Currency in circulation	8.4	6.3	4.0	7.3	6.8

Source: NBS.

[11] 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.

[12] Estimated GDP over the last four quarters.

Chart IV.2.2 **Contribution to y-o-y growth in M2, by sector**
(in pp)



Source: NBS.

Household and corporate sectors provided the strongest contribution to y-o-y growth in M2.

3nd contributions for mandatory social insurance.[13] Still, the major portion of liquidity was withdrawn with the NBS FX sales in the IFEM in Q3 (RSD 26.6 bln).

In terms of the structure of dinar reserve money, the strongest growth was recorded for balances in banks' gyro-accounts (RSD 17.9 bln). Cash in circulation expanded by RSD 8.6 bln, and required reserves allocated in dinars by RSD 5.4 bln. Deposit surpluses held by banks with the NBS fell by RSD 7.0 bln and vault cash by RSD 1.5 bln. Balances in the accounts of local authorities also declined (RSD 0.7 bln).

Money supply increased in Q3, with the smallest real growth posted by M1 (3.7%). A significant increase in FX deposits and longer-maturity dinar deposits pushed up broader monetary aggregates M2 and M3 by 5.4% and 4.2% respectively. Y-o-y, growth in money supply decelerated as of August. For instance, in September M1, M2 and M3 gained 13.7%, 10.7% and 4.4% in real y-o-y terms respectively. Lending to the private sector and bank purchases of government securities had the strongest impact on M3 creation in Q3.

Demand deposits went up RSD 7.5 bln in Q3, mainly reflecting rising balances in the accounts of enterprises (RSD 14.7 bln). Growth was recorded for almost all sectors, but was the most pronounced in trade, manufacturing, and electricity, gas, steam and air conditioning supply sectors. A sharper drop in transaction accounts was noted only for OFOs (RSD 9.7 bln). At the same time, OFOs raised their balances in longer-maturity dinar deposit accounts to a similar extent.

Balances in dinar savings and term deposit accounts went up RSD 15.7 bln. After OFOs, the highest increase in deposits was recorded on enterprise accounts. The growth in these deposits, including other deposits of enterprises, was partly due to the disbursement of subsidised loans. A reduction in account balances was recorded only for local authorities.

Relatively low household income, the holiday season and falling deposit rates, slowed down the growth in household savings. In Q3, dinar and FX savings rose RSD 0.5 bln and EUR 19.4 mln, reaching RSD 39.8 bln and EUR 8.2 bln by end-September respectively.

Total FX deposits were up EUR 125.9 mln in Q3, reflecting an increase in balances in FX accounts of enterprises (EUR 169.3 mln), primarily from the energy sector. Balances in accounts of non-profit organisations increased negligibly as well.

Loans

An upturn in lending, set in motion in June, continued into Q3. Excluding the exchange rate effect[14], domestic loans were up 1.9% in Q3. The share of domestic loans in estimated GDP[15] rose 1.1 pp to 46.9% in September.

Y-o-y, the downturn in lending slowed further, to 1.8% in September. The y-o-y decline in corporate lending decelerated to 5.5%, whereas the rise in household lending continued to 5.2%. Excluding the receivables of delicensed banks, domestic lending activity has stagnated since August.

In financing their lending activity, banks tapped domestic sources in Q3.

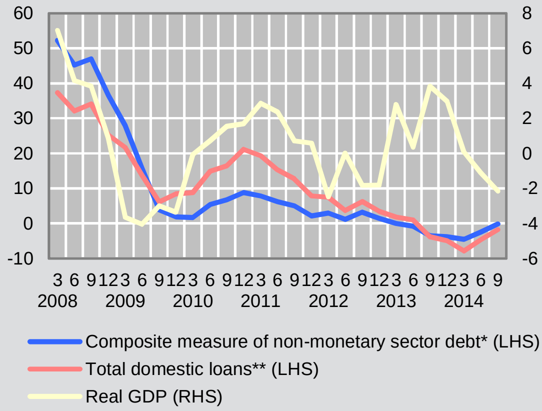
Excluding the exchange rate effect, corporate lending was up RSD 2.6 bln or 2.0% in Q3. The growth materialised greatly owing to the extension of subsidised loans for liquidity maintenance and financing of durable current

[13] Such trends are generally seasonal – VAT collection from entities obliged to make quarterly payments, the stocking of cigarettes prior to the regular July excise adjustment, and increased fuel consumption over the start of the harvest and more intensive transit transport. The increased collection of excises on petroleum products was partly due to the labelling of fuel within the effort to combat the grey economy.

[14] Calculated at the RSD/EUR exchange rate as at 31/08/2008, assuming that all FX and FX-indexed loans were approved in euros.

[15] Estimated GDP over the last four quarters.

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



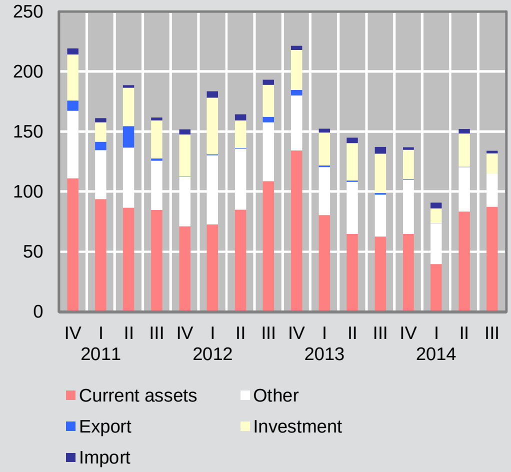
Sources: NBS and SORS.

* As an indicator of total borrowing, it includes domestic loans to the private sector, public enterprises and local authorities, and enterprise cross-border borrowing.

** Excluding the exchange rate effect.

A y-o-y fall in domestic lending slowed further in Q3.

Chart IV.2.4 **Structure of new corporate loans**
(in RSD bln)

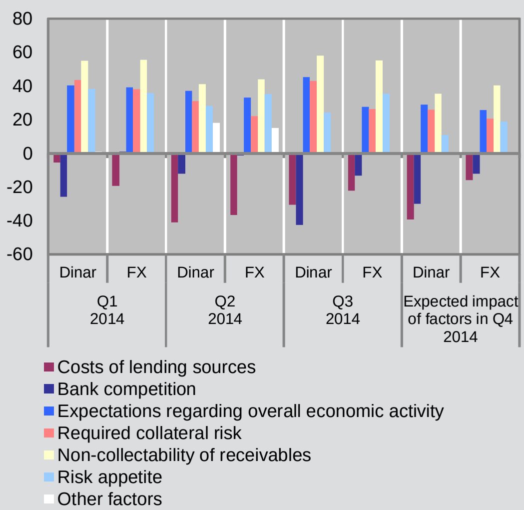


Source: NBS.

The major portion of new corporate loans was intended for current assets financing.

assets. However, partly because of saturated demand, these loans were disbursed at a slower pace than at the programme start. According to data of the Development Fund of the Republic of Serbia, Q3 saw the disbursement of subsidised loans worth RSD 55.7 bln, or RSD 90.6 bln[16] since the programme was launched. The highest Q3

Chart IV.2.5 **Impact of factors on corporate lending standards**
(in net percentage)

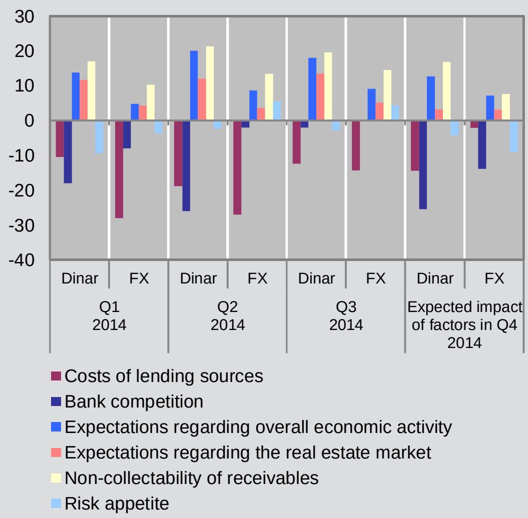


Source: NBS.

* Positive value = contribution to tightening; negative value = contribution to easing.

Though the costs of funding sources contracted further, the standards were tightened over increased risk perception.

Chart IV.2.6 **Impact of factors on household lending standards**
(in net percentage)



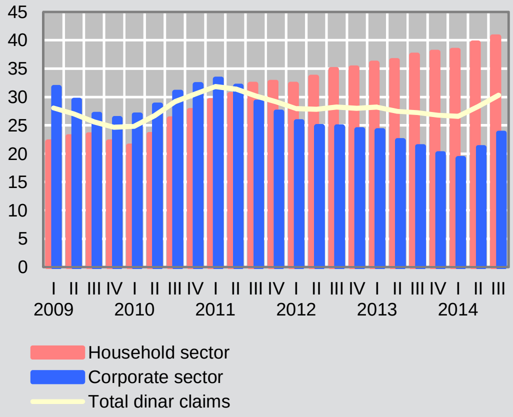
Source: NBS.

* Positive value = contribution to tightening; negative value = contribution to easing.

Banks expect the loosening of standards in Q4.

[16] As at 2 October 2014.

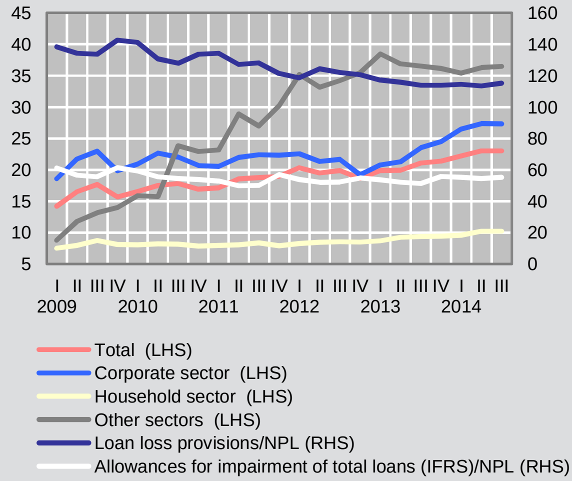
Chart IV.2.7 **Share of dinar in total bank receivables on corporate and household sectors**
(in %)



Source: NBS.

The dinar debt of corporate and household sectors continued up, including their resilience to potential exchange rate changes.

Chart IV.2.8 **NPLs share in total loans, gross principle**
(in %)



Source: NBS.

The share of NPLs in total loans remained unchanged relative to end-Q2.

performance was recorded in July, though it slowed in August and September. In addition, banks assigned a portion of due receivables to non-financial entities, which, together with the earlier approved loans falling due, exerted a negative impact on lending activity. Current assets loans were approved to the greatest extent, making up two-thirds of new corporate loans. The adverse economic situation and the absence of capital investments have underlain the reduced extension of investment loans for quite a long period already.

According to the NBS October bank lending survey[17] and contrary to expectations from the July survey, banks tightened further their corporate lending standards in Q3. Despite the reduced costs of corporate lending sources, standards were tightened in light of elevated risks related to the collection of receivables and collateral, and unfavourable expectations as to the economic activity. The terms of borrowing by enterprises were more favourable because of lower margins and the accompanying costs. At the same time, the bank criteria relating to the maximum amount of loan and collateral were tightened. Loan demand of enterprises increased in Q3 as well, and pertained to dinar loans only. It originated from SMEs and was led by the need to finance current assets and restructure debts. The same factors are likely to be the main instigators of the expected growth in demand in Q4.

In Q3, household lending bounced back by RSD 11.8 bln or 2.6% (excluding the exchange rate effect). Cash loans were predominant. Housing loans were somewhat less popular than in Q2, which may be linked to the seasonal factor and weaker trading volumes in the real estate market. Household borrowing under costlier categories – revolving loans, credit cards and current account overdrafts, stayed at the similar level as in the prior months.

According to the October bank lending survey, contrary to expectations, some banks tightened standards for household lending as well, driven by the same motives as for corporate lending. On the other hand, interest margins and the accompanying costs were reduced, and citizens were offered more favourable repayment terms. As assessed by banks, household demand for loans increased in Q3 as well, notably because of the need to refinance the existing obligations. Higher demand for cash dinar loans was particularly pronounced, whereas demand for consumer and housing loans decreased. Still, the adverse situation in the labour market and low household income had a negative impact on citizens' decisions to borrow.

By end-September, 30.3% of corporate and household loans were dinar-denominated, up by 2.0 pp from June. The degree of dinarisation increased particularly in the corporate sector, where the share of dinar loans, under the impact of subsidised lending, went up 2.5 pp to 23.6%.

[17] The NBS began conducting the survey in early 2014. Participation is voluntary and the response rate almost 100%.

Households continued to borrow predominantly in dinars – in Q3, the share of dinar in total household loans increased by an additional 1.1 pp to 40.6%.

The share of NPLs in total loans, under the gross principle, remained unchanged from end-Q2, equalling 23.0% in September. The upward trend in the share of NPLs was halted through disbursements of subsidised loans. Thus, the share fell 0.1 pp to 27.3% in the corporate sector, while remaining unchanged in the household sector relative to June (10.2%). However, despite the high share of NPLs in total loans, the capital adequacy ratio of 19.4% is indicative of unimpaired stability of the domestic banking sector. Allowances for impairment equalled 55.3% of NPLs in September. At 115.2% in September, loan loss provisions[18] fully covered the amount of gross NPLs.

3. Real estate market

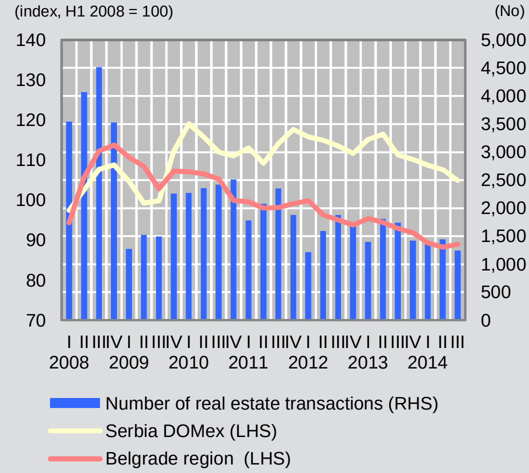
The signs of recovery of the real estate market are still not in sight – property prices slumped further in Q3 and the turnover followed suit.

In Q3 DOMex[19] lost another 2.5% q-o-q and 5.7% y-o-y. A slight index increase was recorded only for the Belgrade region (0.8%), whereas other parts of Serbia experienced a decline.

The activity in the real estate market was lower than in Q2. The number of real estate transactions[20] in Q3 equalled 1,247, one of the lowest quarterly figures since the start of the statistics in 2007. Property prices spiralled further down, so the average price in Q3 came at EUR 868.4 per m2.

Despite the drop in prices, relatively low income makes citizens increasingly reluctant to buy an apartment. To illustrate, it would take 9.6 years for an average income household[21] to buy an apartment of 60 m2, provided they spent all their earnings for this purchase. The National Bank of Serbia's bank lending survey from October shows a contraction in housing loan demand in Q3, and banks expect this trend to extend into Q4. Considering

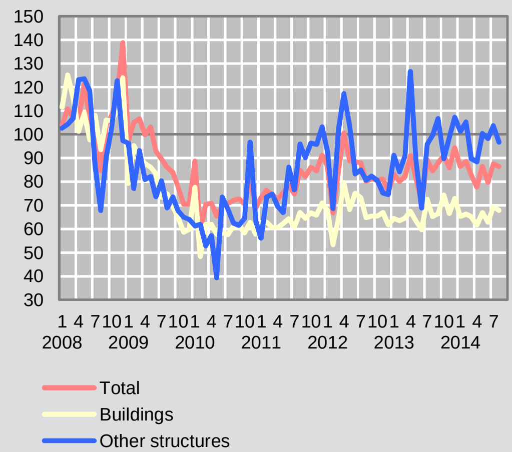
Chart IV.3.1 **DOMex and real estate transactions**



Source: National Corporation for Insurance of Housing Loans.

Property prices and turnover were both on decline in Q3.

Chart IV.3.2 **Indices of the number of issued construction permits**
(s-a data, H1 2008 = 100)



Sources: SORS and NBS calculation.

The number of issued construction permits for residential housing increased in July and August.

[18] Loan loss provisions are not an accounting category, meaning they are not recorded in the income statement but serve to calculate bank capital. They are calculated on the group basis by assets classes that provisioning levels are defined for (0%, 2%, 15%, 30% and 100%, of receivables classified in A, B, C, D and E categories, respectively).

[19] DOMex is published by the National Corporation for Insurance of Housing Loans and relates only to real estate purchased by insured loans. It shows the ratio of the average value all achieved prices per square meter in a particular period to the average value of all achieved prices per square meter in a base period. Though it does not monitor purchase/sale transactions financed by own funds or uninsured loans, DOMex is judged to mirror the trends in the real estate market, in light of high unemployment, plummeting wages and muted credit activity.

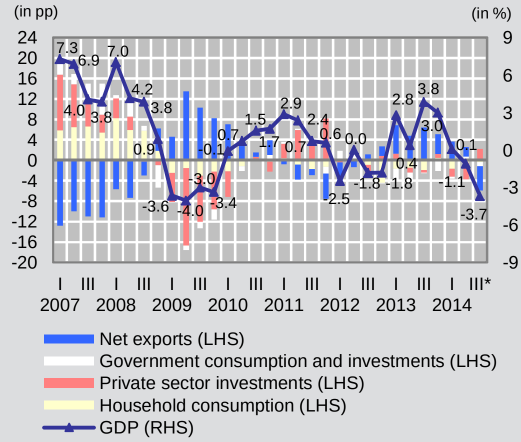
[20] The number of real estate transactions and apartment prices per square meter also concern only the real estate purchased by insured loans.

[21] Source: Serbian Statistical Office, Household Budget Survey.

the above, along with the public sector wage cuts, a rebound in property demand is not likely in the coming period either.

At the same time, the supply of new apartments is not expected to increase to any relevant extent. Although the number of building construction permits rose by 7.6% s-a[22] from the quarter before, it still remains by one third lower relative to the pre-crisis period[23]. The unfavourable trend in construction is also evident from the fact that the number of employees in the sector melted by 1.5 times compared the period before the crisis and that more than half of the loans extended to construction enterprises are classified as NPLs. The situation in the industry could be improved by the entry of foreign investors who could engage domestic construction companies. The Government already adopted some reform laws and additional ones are in the pipeline that could contribute to the improvement of investment climate in Serbia.

Chart IV.4.1 **Contribution to y-o-y GDP growth rate − expenditure side**



Sources: SORS and NBS calculation.
* NBS estimate.

A strong fall in exports in Q3 pushed aggregate demand further down, while private investments grew on the back of the increase in agricultural products inventories.

4. Aggregate demand

Negative effects of floods and dwindling export demand led to a negative contribution of net exports to aggregate demand movements in Q3. Both private consumption and investments in fixed assets were on decline, but positive impetus came from domestic demand thanks to an increase in inventories of agricultural products. The fall in demand accelerated y-o-y, primarily due to a contraction in exports and investments in fixed assets.

GDP contraction in 2014 will result exclusively from lower domestic demand, primarily private consumption and private investments, while net exports are expected to provide a neutral contribution.

Aggregate demand dwindled further in Q3, losing 1.0% s-a. The fall was prompted mainly by a continuation of adverse trends in external trade, the key drags being the contraction in motor vehicle exports and a rise in energy imports. Within domestic demand, private consumption and investments in fixed assets shrunk, while government consumption and inventories went up.

According to the preliminary estimate of the Serbian Statistical Office, aggregate demand plunged by 3.7% y-o-y in Q3. Net exports exerted a downward pressure (4.8 pp), while domestic demand gave a positive contribution (1.1 pp), primarily through an increase in inventories of agricultural products.

Judging by its movements in the year so far, we expect aggregate demand to record a fall in 2014 as a consequence of lower private and government consumption and lower private investment.

[22] July and August.
[23] H12008.

Text box 1: Fiscal policy performance in 2014

Since the beginning of the year government spending was more or less in line with budget expenditure plans. However, as the budgetary revenues underperformed, steps were taken to review the budget performance and the revised budget was adopted in late October. The revised budget has set the deficit of the Republic of Serbia at RSD 225.0 bln (5.7% of GDP) i.e. about one fourth above the originally planned amount. Actually, the budgetary deficit of Serbia in 2014 was originally set at RSD 182.6 bln[1], i.e. 4.7% of GDP and the consolidated budget deficit at 5.5% of GDP.[2]

The revised budget envisages a cut in revenues by about RSD 30 bln and an increase in expenditures of about RSD 10 bn. Within the revenues, the strongest underperformance was recorded for the collection of revenues from VAT and excise duties (RSD 32 and RSD 16 bln, respectively). The lower than planned VAT revenues came about primarily as a result of the decline in GDP and the set back as regards the expected higher revenues in 2014 from curbing grey economy. At the time the 2014 budget was originally planned, GDP growth was forecast at 1%. It however now seems rather certain that GDP will fall. Also, the average rate of inflation assumed at the time of the budget planning was 5.5%, which is above the rate that will be achieved in 2014 (about 2.1%). Based on the assessment of the Fiscal Council, the rate level of VAT collection has remained almost unchanged from the year before. On the other hand, the revenues from collection of excise duties point to a probable shrinking of shadow trading in oil derivatives market and, at the same time, to its probable increase in tobacco products market.[3] The only category of tax revenue to surpass the original expectations is the revenues from corporate profit tax (by about RSD 8 bln).

On the expenditure side, the strongest increase is envisaged for subsidies (by RSD 13 bln)[4]. This increase mainly relates to payment of government liabilities to banks on account of subsidized loans granted in earlier years (RSD 8 bln), and the rest mostly to state-owned enterprises with poor performance. Also, an increase is also forecast for some other government expenditures, primarily as they relate to flood damage and other disaster relief (RSD 7 bln)[5] and the payment of fines and damage compensations (RSD 5.5 bln). On the other hand, expenditures for public investment are revised down by RSD 4 bln.

In order to finance higher budget deficit, the revised budget envisages increased issuance of securities in the domestic (by RSD 120.0 bln) and international market (by around RSD 80 bln)[6] while, on the other hand, loan disbursements will be cut down (by about RSD 120 bln, primarily on account of non-inclusion of a part of the loan from the United Arab Emirates). The increased gross borrowing by the state (by about RSD 80 bln), along with the projected increase in government account holdings (by around RSD 60 bln), probably reflects the intended use of the currently favourable conditions of borrowing in the international market.

The most important measure included in the revised budget relates to public sector wage and pension cuts from November. The revised budget envisages a linear decrease in wages by 10% (wages higher than RSD 25,000) in the general government sector, public enterprises and other legal entities in the public sector, and progressive reduction of pensions by 22% (the amount above RSD 25,000), i.e. 25% (the amount above RSD 40,000). Since this measure will only be applied in the last month of the year because November wages and salaries are paid out in December, it shall not have a significant impact on lowering of the deficit for 2014 but certainly shall have an effect on the public sector expenditure in 2015. It is estimated that the annual saving under this scenario will come up to around RSD 48 bln.

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[1] The Law on the Budget of the Republic of Serbia for 2014.

[2] Pursuant to the Fiscal Strategy for 2014 including projections for 2015 and 2016.

[3] Relative to changes in tax base, a somewhat higher increase is recorded in the collection of excise duties on oil derivatives, but also a significant drop in revenues from excise duties on tobacco products, which are the lowest in the last ten years.

[4] The increase in expenditures relative to the amount planned would have been higher if the redundancy payments had been made to workers in enterprises undergoing restructuring (about RSD 15 bln). These expenditures shall be included in government expenditures for 2015.

[5] A portion of these expenditures has been covered from unplanned revenues from donations (RSD 4.5 bln) thereby partly offsetting the impact of these expenditures on the budget deficit.

[6] Pursuant to Article 2 of the Law Amending and Supplementing the Law on the Budget of the Republic of Serbia for 2014, in case it is not possible to secure funds in the planned proportion between loans and government securities issued in the domestic and foreign financial market, it is possible to change the structure of the given sources of funds, on condition the overall amount of funds planned for a given purpose is not exceeded (RSD 740.8 bln).

Table O.1.1 **Republic of Serbia budget for 2014**
(in RSD thousand)

	Budget Law	Budget revision	Difference
Revenues	**930**	**897**	**-33**
Customs duties	30	31	2
Excise duties	228	211	-16
on oil derivatives	113	118	5
on tobacco	99	80	-20
other	15	14	-2
VAT	430	398	-32
at home	146	104	-41
from exports	282	291	9
Personal income tax	48	44	-4
Corporate profit tax	58	66	8
Other tax revenues	10	9	0
Non-tax revenues	122	130	8
Grants	5	8	2
Expenditures (excluding debt repayment)	**1,112**	**1,122**	**9**
Expenditures for employees	272	264	-8
Purchase of goods and services	97	99	2
Interest payment	114	112	-1
on domestic debt	**56**	**57**	**1**
on external debt	48	46	-2
on guarantees	9	9	0
Subsidies	81	94	13
in economy	8	18	9
in agriculture	35	34	-1
other	38	42	4
Transfers to other levels of government	72	74	2
Transfers to social insurance organisations	283	281	-3
Social protection financed from the budget	107	111	4
Other current expenditures	18	30	13
Capital expenditures	51	46	-4
Aquisition of financial assets	19	12	-7
Balance	**-183**	**-225**	**-42**

Source: Ministry of Finance.

Fiscal policy measures adopted so far represent a step forward in the implementation of fiscal consolidation needed to secure sustainability of public finances. Based on our estimate, the overall consolidated budget deficit in 2014 will be significant and will amount to around 7.5% of GDP. Note that also included here are the "below the line" expenditures which generally imply financial transactions by the government, like payment of called up guarantees, capitalisation of banks and enterprises, acquisition of debts of other public sector entities, etc. At the moment, these expenditures account for about 2% of the annual GDP and their execution to date has reflected on the increase in public debt.

In late September, public debt amounted to EUR 22.1 bln, i.e. 67.5% of GDP[7]. By implementing the announced additional measures of fiscal consolidation and structural reforms, assuming an arrangement with the IMF is concluded, we expect that the public debt could stop rising by the year 2017, and start decreasing from then on.

Table O.1.2 **Financing of budget deficit**
(in RSD bln)

	Budget Law	Revision	Difference
Net	**-183**	**-225**	**-42**
Borrowing	663	742	79
Securities issuance in the domestic market	330	450	120
Securities issuance in foreign markets	69	150	81
Loans	264	141	-123
Sale of domestic financial assets	0	1	1
Debt amortisation	480	460	-20
to domestic investors	385	345	-40
to foreign investors	38	36	-2
Repayment of principal under guarantees	41	47	6
Aquisition of financial assets	16	31	15
Changes in account balances	0	57	57

Source: Ministry of Finance.

[7] Preliminary data.

Domestic demand

Our estimates show that after stagnating in Q2, **private consumption** contracted moderately in Q3 (0.4% s-a), giving a negative 0.3 pp contribution to total demand. In the year to date, private consumption also recorded a y-o-y fall, which amounted to 0.5% in Q3. This is also indicated by movements in its key indicators – retail trade turnover, which fell by 1.5% s-a in Q3, and consumer goods imports, which slid by 1.6% s-a.

According to our estimates, there was no increment in private consumption, despite a mild growth in its sources. The real wage and pension bill, as the main source of income for private consumption, edged up slightly, as well as the volume of consumer loans, while foreign remittances dwindled. One of the possible explanations as to why the consumption did not rise can be sought in the announcement of public sector wage and pension cuts from November. Due to these cuts, this component of aggregate demand is expected to remain low in the coming period as well.

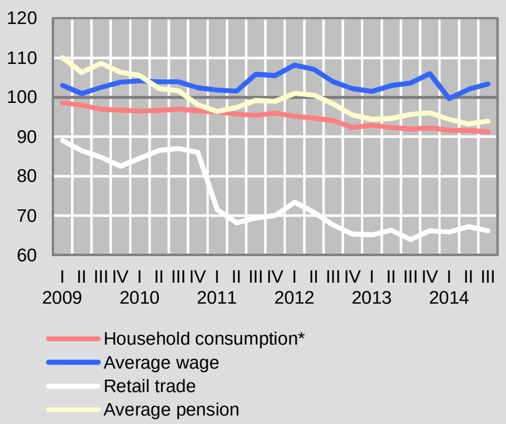
In Q3, **private fixed investments** continued to fall s-a (1.6% s-a), while decelerating the y-o-y decline, from 14.6% in Q2 to 5.0% in Q3. Indicators for these investments confirm a decline in Q3, given the decrease in effective work hours in construction and imports of equipment. However, the increase in the number of building permits issued and the boost in the production of construction material in Q3 could signal a rebound in this component of aggregate demand in the coming quarters.

A positive contribution to aggregate demand movements in Q3 came from an increase in **inventories**, primarily in agriculture, because of the good outturn in the current year.

Government consumption is estimated to have edged up slightly in Q3 (0.4% s-a), giving a positive contribution to aggregate demand of 0.1 pp. This is signalled by higher outlays for the purchase of goods and services, which to some extent stem from flood remediation efforts. On the other hand, public sector wage bill was downsized further. The solidarity tax and public sector employment ban accelerated the y-o-y fall in government consumption to 2.3% in Q3.

The upswing in **government investment** from H1 was halted in Q3. With the cutting down of capital expenditures[24] in the adopted revised budget, the contribution of this component to aggregate demand,

Chart IV.4.2 **Household consumption**
(s-a data, H1 2008 = 100)

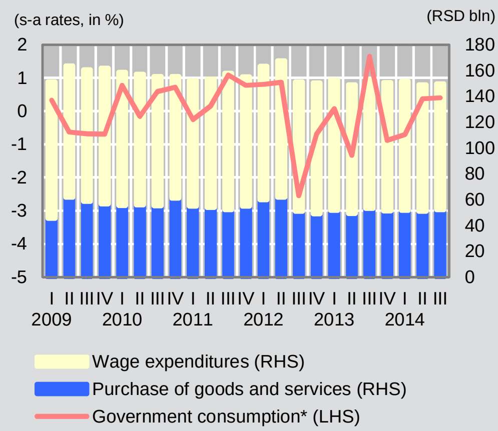


Sources: SORS and NBS calculation.

* NBS estimates for Q3 2014.

A drop in retail trade turnover and imports of consumer goods indicates a further contraction in private consumption in Q3.

Chart IV.4.3 **Government consumption**
(in real terms)



Sources: SORS, Ministry of Finance and NBS calculation.

* NBS estimate for Q3 2014.

Higher outlays for the purchase of goods and services drove final government consumption up in Q3.

[24] See Box 1 on page 26.

Table IV.4.1 **Investment indicators**

	2013		2014		
	Q3	Q4	Q1	Q2	Q3
Real indicators (seasonally-adjusted, quarterly growth, in %)					
Hours worked in construction	0.3	-0.8	2.6	-7.8	-4.1*
Industrial inventories	-0.7	2.8	14	0.7	-3.1
Industrial production of capital goods (physical volume)	11.7	-2.2	-9.1	-18	2.6
Exports of equipment**	16.4	-7.8	21.3	-7.6	-2.8
Imports of equipment**	-16	0.6	-6.1	13	-2.5
Inventories of capital goods	0.6	-2.1	-9.7	0.1	-0.2
Industrial production of intermediate goods (physical volume)	3.1	2.4	-4.0	-6.0	2.8
Exports of intermediate goods**	4.9	0.2	11	-0.9	-0.9
Imports of intermediate goods**	-0.2	-12	2.1	-5.1	-2.4
Inventories of intermediate goods	6.0	11	2.7	2.6	-0.5
Industrial production of construction materials (physical volume)	-11	-3.0	8.9	-6.8	4.0
Inventories of construction materials	0.4	-7.1	4.5	-3.4	-7.3
Government investment***	5.0	-8.7	10.5	4.6	-6.0

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

while remaining positive, will still turn out lower than expected by the year-end.

Net external demand

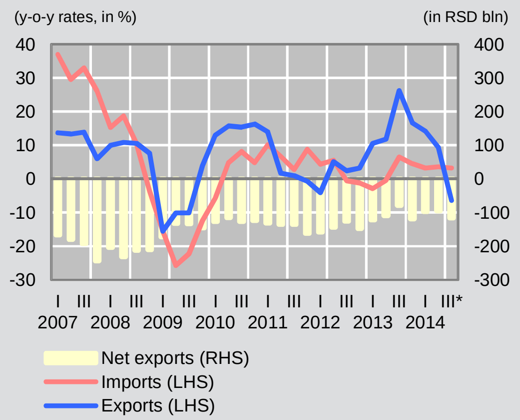
Following a modest rise in H1, real exports of goods and services contracted in Q3 by 3.6% s-a, while real imports continued their quarterly growth (0.9% s-a). As a result, net exports provided a negative contribution to aggregate demand equivalent to 2.2 pp. Y-o-y, after nine consecutive quarters of growth, real exports recorded a 6.4% decline in Q3, driven largely by reduced exports of motor vehicles, which were at their historical high in the same quarter a year earlier. Real imports of goods and services continued to rise from Q2 on the back of increased energy imports in the wake of the flooding and falling import prices. In fact, they rose 3.3% y-o-y in Q3. With exports falling and imports rising at y-o-y level, net exports provided a negative contribution to aggregate demand equivalent to 4.8 pp.

The real effective exchange rate of the dinar depreciated by 1.8% in Q3, leading to an improvement in Serbia's price competitiveness. The improvement can be put down to the 2.2%[25] nominal depreciation of the effective exchange rate, which was partly offset by the faster growth in domestic relative to foreign prices. Improved price competitiveness is expected to moderate the negative effects of the slowing euro area growth on the demand for Serbian exports. A possible decrease in that demand is also indicated by the movement of the leading indicator of external demand for Serbian exports[26], which marked some losses in Q3, but nonetheless remained above its long-term trend.

Euro-denominated commodity exports declined by 7.2% s-a in Q3 amid a slump in the exports of automobile industry and, to a lesser extent, agricultural products. Besides, the exports of base metals and metal products also decreased, which could be linked with the slackening pace of global growth and the consequently weaker demand. A fall was also observed in the exports of rubber and plastic products, which can be connected with the movements in the automobile and oil industry.

The exports of motor vehicles plunged by around 20% s-a in Q3, reflecting mainly the slowing pace of exports in

Chart IV.4.4 **Exports and imports of goods and services**
(in previous-year constant prices, ref. 2010)



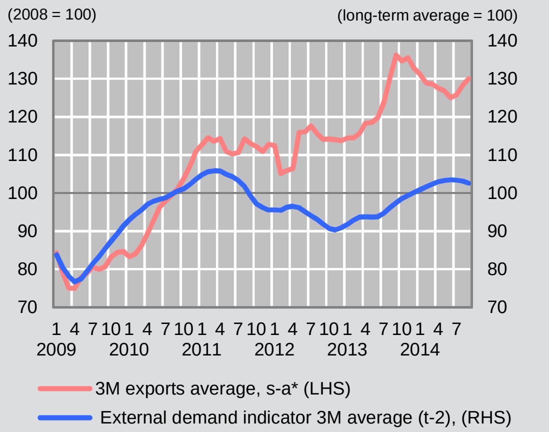
Sources: SORS and NBS calculation.
* NBS estimate.

A strong exports decline in Q3 has largely contributed to a y-o-y fall in aggregate demand.

[25] Calculated as the geometric average of nominal EUR/RSD and USD/RSD exchange rates, with 0.8 and 0.2 weights respectively, i.e. by the formula $(EUR/RSD)^{0.8}*(USD/RSD)^{0.2}$.

[26] 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.

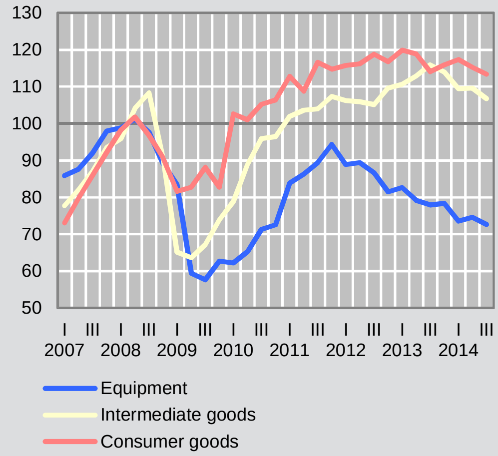
Chart IV.4.5 **External demand and Serbian exports**



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

A slowdown in growth of our main trade partners weighted on export demand.

Chart IV.4.6 **Imports by key components**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

A decrease in investment and final consumption pulled down all components of commodity imports.

August which coincided with the collective annual vacation at the company Fiat Automobiles Serbia. The exports of that company in the first nine months of 2014 came at EUR 1,068 mln, close to last year's level, which is why they are expected to provide a neutral instead of a positive contribution to the narrowing of the current account deficit this year.

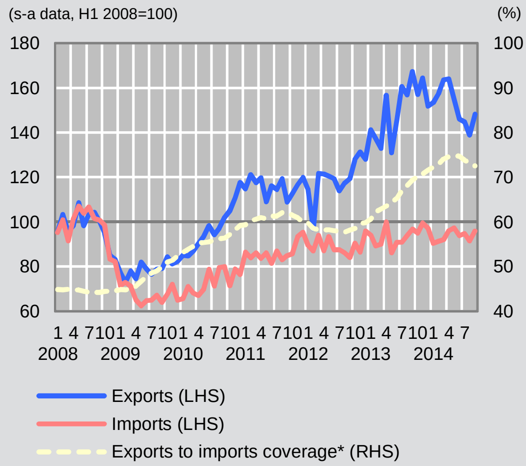
A considerable fall in exports in Q3 was also registered for agricultural products (around 20% s-a). This fall is in part attributable to high exports in Q2, given that a major portion of inventories was exported earlier than in the previous years due to the downward movement of international prices since May. Furthermore, good cereal yields in most countries resulted in a smaller volume of commodity futures and hence, reduced deliveries in Q3, i.e. immediately after the harvest when cereal exports tend to be the highest. This is also confirmed by the almost halved quantity of wheat exports in Q3 compared to the same period a year earlier. On the other hand, high y-o-y growth in corn exports (by around 70%) can be put down to the extremely low base last year when export inventories were low because of a bad agricultural season. At quarterly level, corn exports were by around 65% lower than in Q2.

At the same time, a rise was recorded for the exports of petroleum products (17.9% s-a), leading to a fall in their inventories. The exports of food products also went up (3.4% s-a), while exports of chemical products and electrical equipment perked up following a drop in Q2. Positive contributions to commodity exports were again generated by articles of apparel, pharmaceutical products, tobacco and tobacco products.

Euro-denominated commodity imports also declined in Q3 (1.7% s-a), chiefly owing to reduced imports of intermediate goods (2.6% s-a). This is confirmed by the negative trends in industrial production, considering that a large part of the raw materials in industry is imported. A contraction in imports, though on a smaller scale, was also recorded for equipment (2.5% s-a), indicating a fall in investment consumption, and for consumer goods (1.6% s-a), which could be regarded as a consequence of a cutback in the final consumption of households and the government pending new fiscal consolidation measures.

Looking at broad economic classes, imports of capital and intermediate goods decreased (9.2% and 2.4% s-a, respectively), imports of durable and non-durable consumer goods stagnated, while those of energy increased (11.7% s-a). Energy imports went up largely on the back of electricity imports which increased in Q3 by 80.9% y-o-y as the May flooding caused significant damage to domestic production capacities. Imports of natural gas also stepped up (15.4% y-o-y) as a result of

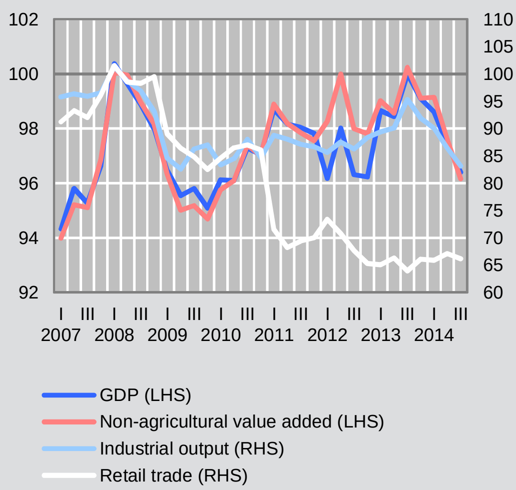
Chart IV.4.7 **Commodity trade in euros**



Sources: SORS and NBS calculation.
* 12-month moving average.

Q3 drop in exports caused a mild decline in exports to imports coverage.

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



Sources: SORS and NBS calculation.

The slowdown in economic activity in Q3 was mainly driven by a strong fall in industrial production.

filling to capacity the underground gas storage Banatski dvor ahead of the winter season. Lower imports of crude oil (3.5% y-o-y), on the other hand, can be linked to the halted production in the Pančevo refinery pending overhaul planned for September.

As exports fell more than imports, foreign trade indicators deteriorated mildly in Q3. The export to import cover ratio slid by 2.2 pp, to 72.6%[27] in September. Still, at end-Q3, commodity exports were 48.2% above and imports 4.0% below their pre-crisis levels[28].

5. Economic activity

The slowdown in growth of Serbia's main external trade partners and negative effects of May flooding continued to weigh on industrial production in Q3, which accelerated the y-o-y fall of GDP to 3.7%. On a quarterly basis, GDP declined by 1.0% s-a in Q3, receiving a negative contribution from industrial production and a positive contribution from agricultural production. Revision of GDP data, according to the new national accounts methodology ESA 2010, did not have a significant bearing on real GDP growth rates.

In Q3, the Serbian Statistical Office revised the GDP data for the period 1995–2012 due to alignment with the new methodology (ESA 2010), effective in all EU countries since September. Following the revision, the nominal GDP level rose on average by 7.0% annually, which brought about slight changes in shares of individual macroeconomic indicators in GDP. However, the annual real GDP growth rates did not change significantly through the revision[29].

In Q3, economic activity was still under the heavy influence of May flooding. GDP dropped by 1.0% s-a, reflecting a further decline in industrial production (3.9% s-a) primarily in mining and quarrying and electricity, gas, steam and air conditioning supply, while the growth in agricultural production partially softened the fall.

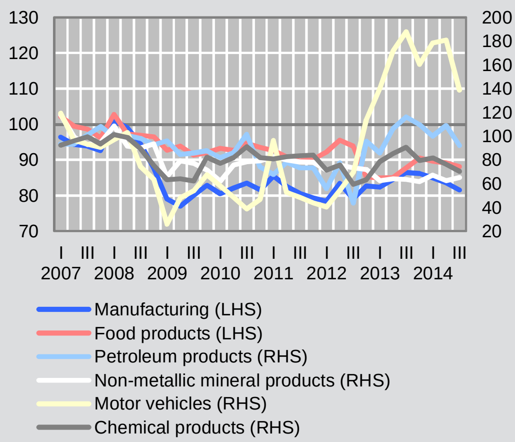
Continuing down in Q3, GDP moved still further from the pre-crisis level[30], down by 3.6%. A strong decline in industrial production weighted on economic activity measured by NAVA in Q3, bringing it down by 1.5% s-a to 3.8% below the pre-crisis level.

In Q3, industrial production fell the most through further shrinking of the physical volume of production in electricity, gas, steam and air conditioning supply by 18.5% s-a and in mining and quarrying by 15.1% s-a. Nevertheless, the latter sector saw some nascent signs of recovery, thanks to the rehabilitation and start-up of the coal mine Veliki Crljeni, as confirmed by the 40.3% s-a

[27] 12-month moving average.
[28] H1 2008.

[29] See Box 2 on page 34.
[30] H1 2008.

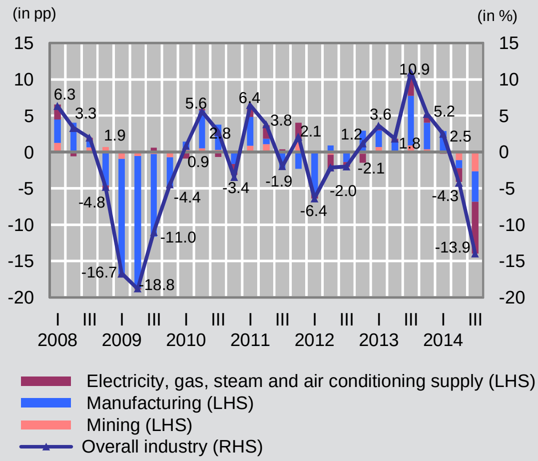
Chart IV.5.2 **Physical volume of production by branches of manufacturing industry**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Lower physical volume of production in majority of key export sectors of manufacturing indicates a contraction in export demand.

Chart IV.5.3 **Contributions to y-o-y growth of the physical volume of industrial production**



Sources: SORS and NBS calculation.
* NBS estimate.

The fall in industrial production in Q3 accelerated y-o-y due to floods and lower export demand.

increase in the physical volume of production in coal exploitation in August.

Physical volume of production in manufacturing shrunk by 2.4% s-a in Q3. Such movements were prompted primarily by a lower production of motor vehicles, which flatlined in Q2 and lost 23.3% s-a of its physical volume in Q3. This is attributable to a halt in production in Fiat Automobiles Serbia during a collective annual vacation in August. Apart from automobile industry, production of petroleum products also shrunk in physical volume by 15.4% s-a, after the Pančevo refinery halted its production in September, due to the planned overhaul and modernisation of production capacities. The physical volume of production of chemical products linked to oil industry also contracted. Downsizing was registered for pharmaceuticals, electrical equipment and rubber and plastic products which account for a large share of exports, which may indicate a tapering of export demand.

On the other hand, the production of computers and computer equipment expanded in physical volume, as well as the production of base metals, after the reignition of Smederevo blast furnace in July. Production of construction materials, wood processing and production of machinery and equipment also saw positive movements.

The greatest positive contribution to economic activity in Q3 came from the agriculture sector, as confirmed by the favourable outturn of this year's harvest of cereals and industrial plants. Preliminary estimates of the Serbian Statistical Office indicate an increase in the production of corn by some 25%, soya beans by around 20% and sugar beet by around 5%, while sunflower production is expected to linger around the last year's level. Wheat production fell by 14% due to the high base from the last year[31]. In addition, the 2014 outturns for all mentioned crops should significantly exceed the ten-year averages.

Construction continued to shrink in Q3 (3.3% s-a), as indicated by a lower number of effective hours worked. Nevertheless, some indicators signal improvement. The physical volume of production in the construction sector increased and there was a depletion in inventories, while wood processing, linked with construction works also expanded in physical volume.

In Q3, economic activity in service sectors dwindled almost across the board. Retail trade fell by 1.5% s-a, still lingering by one third below the pre-crisis level.

Preliminary estimates of the Serbian Statistical Office show that GDP fell by 3.7% y-o-y in Q3. The fall was prompted mainly by lower activity in industrial sectors

[31] In 2013, wheat production saw its historical record of 2.7 mln tons.

and construction, while the rebound in agricultural production worked in the opposite direction.

In Q3, the physical volume of industrial production accelerated its y-o-y fall to 13.9%. Such a steep fall resulted from contraction in the physical volume of production across all industrial sectors, as well as from the base effect, bearing in mind that in Q3 2013 industrial production posted its post-crisis high. The sharpest fall of as much as 38.7% y-o-y was recorded for electricity, gas, steam and air conditioning supply, which pushed the overall industry physical volume of production down by 7.1 pp. A somewhat milder fall was reported for mining and quarrying (28.4%, contribution of –2.6 pp), thanks to the prompt rehabilitation of some parts of coal mines submerged in water in Q3.

Manufacturing also saw lower physical volume of production in Q3 (5.6% y-o-y), mainly due to shrinking export demand. This is also confirmed by a y-o-y fall in physical volume of export-oriented motor vehicle production, which amounted to 26.0%. A strong contraction in the physical volume of production of 16.1% y-o-y was also recorded for petroleum products due to the overhaul in Pančevo refinery. The volumes of production also shrunk across other segments of the manufacturing industry which boast rich export-oriented product assortments (production of chemical, metal and rubber and plastic products). Y-o-y growth in physical volume was recorded for production of machinery and equipment, computers and wood processing.

Given the H1 trends and preliminary estimates for Q3, GDP is poised for a decline in 2014. Industrial production is likely to experience a downturn due to the slack in energy, mining and manufacturing. A fall is also expected in the construction industry.

A mild pickup in activity is expected in agriculture whose outturns exceeded the expectations, despite the excessive flood-induced damages. Higher outturn is likely for cereals and industrial plants, given that the major part of areas under these crops were not affected by the flooding. Indicators of activity in cattle breeding have recorded y-o-y growth in the year to date, except for the temporary fall in May, caused by the flooding. This should drive the overall agricultural production up in 2014, bearing in mind that cattle breeding makes up an ample 30% share of the total. By contrast, vegetable and fruit growing were largely affected by floods and are likely to see lower outturns, as confirmed by preliminary estimates regarding this year’s major fruit and vegetable crop harvests.

The slowdown in construction is expected to negatively affect GDP. Economic activity in service sectors is expected to edge down slightly at the year level. Continued growth is likely in transport and information and communications, while trade and other service sectors are expected to see a slump in activity due to the implementation of additional fiscal consolidation measures.

Text box 2: Revisions to Serbia's GDP according to ESA 2010 methodology

Concurrently with the EU countries, the Serbian Statistical Office switched to a new GDP calculation methodology based on ESA 2010 system of regional and national accounts, thus aligning Serbia's statistical system in the area of national accounts with the rest of the Europe. ESA 2010 methodology comprises concepts, definitions and accounting rules for calculation of national accounts data aimed at ensuring international comparability. A new methodological framework seeks to reflect major changes in the economy over the last two decades – an increasing role of information and communication technologies in the production process, increased importance of intellectual property and service sectors, as well as the growing interdependence of national economies.

GDP revision is premised on the two main components – conceptual or methodological changes and changes in statistical scope. The most important conceptual changes concern the treatment of investment into research and development and purchase of military equipment. According to the prior methodology (ESA 1995), assets invested in research and development were treated as a current expenditure within intermediate consumption, while the new methodology recognises these assets as a final product (by production principle), or investment into fixed assets (by expenditure principle). The reasoning behind this change takes into account the key characteristics of investment into research and development, i.e. the fact that they have defined ownership, are spent over a longer time period and represent the most important form of investment in the modern economy. The consequence of this methodological change are higher GDP levels of all countries, more prominently the developed ones which invest sizeable assets in research and development. Also, the purchase of complex combat systems (military equipment) was earlier recognized as intermediate consumption. However, given the long period of their use, under the new methodology they are recognized as investments into fixed assets.

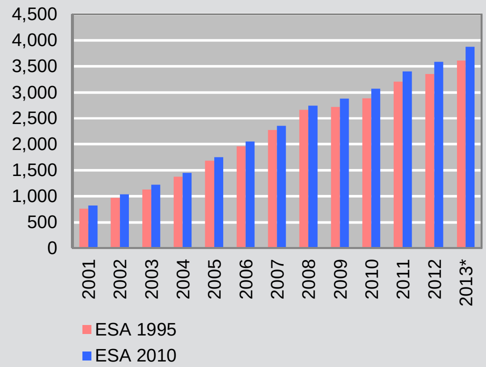
Of statistical changes applied in GDP revision, the most important ones are a more exhaustive coverage of GDP (exhaustiveness) and inclusion of illegal activities in GDP calculation. Exhaustiveness was improved by using a larger number of data sources and improvement of statistical procedures, with a view to ensuring a more precise calculation and better coverage of economic activity. The inclusion of Illegal activities was not a prerequisite for the application of the new methodology, but since all EU countries included them in their GDPs, Serbia followed suit, to ensure international comparability. Illegal activities whose estimated incomes were accounted for in this revision include drugs distribution, prostitution and illegal production and sale of cigarettes and alcohol. Apart from these key changes, statistical procedures were also improved in the parts relating to allocation of FISIM by institutional sectors, better valuation of non-life insurance services in GDP, improvement of data sources as regards taxes and subsidies etc. Also, in GDP conversion from current to constant prices, double deflation method was applied, which deflates separately final production and intermediate consumption. This balances out the production and expenditure sides of GDP in current and constant prices throughout the time series.

The introduction of new methodology for national accounts calculation entailed the revision of GDP data for 1997–2012 and publication of data for 1995 and 1996. Data revision led to an average upward revision of 7% per year to the level of nominal GDP over 1995–2012. Of this, methodological changes arising from transition to ESA 2010 accounted for 0.9 pp, while changes in statistical scope (capturing illegal activities and improvements in data sources) for 6.1 pp. Although the nominal GDP level was pushed up (Chart O.2.1), note that real GDP growth rates have not suffered any major changes (Chart O.2.2). The difference between the real GDP growth rates calculated by the old versus the new methodology over the period 2001 to 2012 amounts to an average 0.7 pp on an annual basis. Under the new methodology, real GDP growth pre-crisis (2001–2008) is higher on average by 0.9 pp, while the real growth in the period 2009–2012 remains almost unchanged (an average annual increment of 0.1 pp).

The upward revision to the level of nominal GDP pushed down the shares of key macroeconomic indicators in GDP (Table O.2.1). So public debt to GDP ratio for 2013 slid down by 4.2 pp to 59.6%, while the ratio of external debt to GDP dropped by 5.3 pp to 75.3%, compared to the unrevised data. Downward revisions were also recorded for the share of current account deficit in GDP in 2013 – from 6.5% to 6.1%, and for consolidated fiscal deficit– from 5.0% to 4.7%.

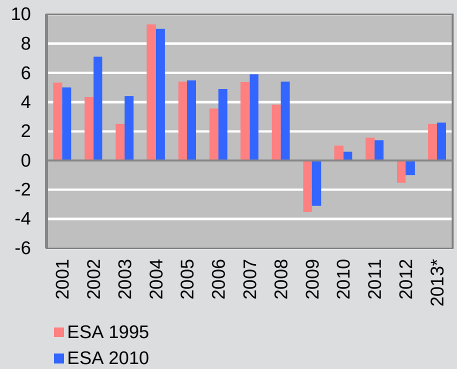
Alignment of Serbian statistical methodology with international standards and application of the latest achievements in this field is also important from the standpoint of data quality improvement. One should bear in mind that successful conduct of economic policy and monetary policy as its integral part, is largely dependent on the reliable and timely statistical data which the new methodology seeks to ensure.

Chart O.2.1 **Revision to nominal GDP**
(in RSD bln)



Source: SORS.
* Preliminary estimate.

Chart O.2.2 **Revision to real GDP growth rates**
(in %)



Source: SORS.
* Preliminary estimate.

Table O.2.1 **Revised shares of most important indicators in GDP**
(% of GDP)

		2008	2009	2010	2011	2012	2013
Public debt	ESA 1995	29.2	34.7	44.5	48.2	60.2	63.8
	ESA 2010	**28.3**	**32.8**	**41.8**	**45.4**	**56.2**	**59.6**
External debt	ESA 1995	64.2	76.9	84.1	76.6	86.6	80.6
	ESA 2010	**62.3**	**72.7**	**79.0**	**72.2**	**80.9**	**75.3**
Consolidated fiscal deficit	ESA 1995	-2.6	-4.5	-4.8	-5.0	-6.6	-5.0
	ESA 2010	**-2.6**	**-4.2**	**-4.5**	**-4.7**	**-6.1**	**-4.7**
Current account deficit	ESA 1995	-21.6	-6.6	-6.7	-9.1	-12.3	-6.5
	ESA 2010	**-21.2**	**-5.8**	**-7.0**	**-9.9**	**-11.5**	**-6.1**

Source: NBS.

6. Labour market developments

Real wages continued to grow in Q3, though faster in the private than in the public sector. Weakening of labour productivity in industry, mostly induced by floods, and the increase in real wages drove unit labour costs up. Indicators captured by the Labour Force Survey signal improvement in the labour market. Unemployment rate slid to 17.6% with informal employment going up, and long-term unemployment and youth unemployment going down.

Wages and labour productivity

Real net wages continued to grow into Q3, replicating the Q2 trend of faster growth in the private then in the public sector (1.8% s-a and 0.5% s-a, respectively). Compared to the pre-crisis period[32], real net wage in the private sector in Q3 was higher by 18.5%, and lower by 10.5% in the public sector.

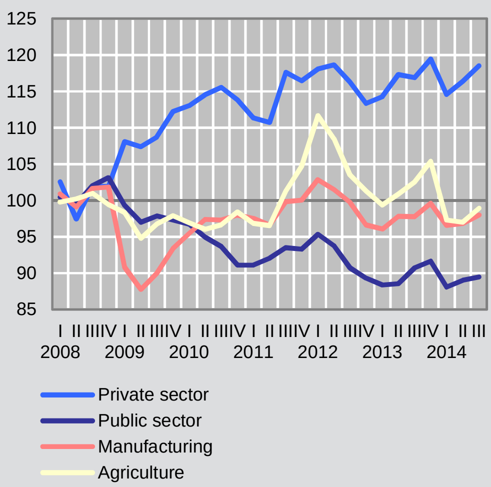
Observed by industry, high real wage growth in Q3 was recorded for construction (by 6.5% s-a) and mining and quarrying (by 4.9% s-a). Tradable sectors of the economy also saw increases in real net wage (agriculture, manufacturing and electricity supply). On the other hand, public government and administration, arts, entertainment and recreation, as well as the financial sector experienced a decrease in real net wage.

Contrary to the quarter earlier, real y-o-y growth of net wage in the private sector was positive and equalled 1.4%. Y-o-y growth was present in information and communications, construction and all industrial sectors, while agriculture, transport and financial activities reported a decrease. Real net wage in the public sector in Q3 slid by 1.4% y-o-y, partly due to solidarity tax and stricter control of wage payments since the central registry was set up in October 2013.

The average nominal take-home wage in Serbia in Q3 stood at RSD 44,929, down by 0.1% from Q2 and up by 2.3% from the same period last year. Real net wage bill also recorded an increment of 0.6%, with an increase in the public and decrease in the private sector. The following quarter is nevertheless poised for a reduction in the public sector wage bill given the Government's decision to cut down wages above RSD 25,000 by 10%.

After the failed negotiations between the trade unions and employers regarding the minimal wage setting, the Government decided to raise the minimum labour cost to RSD 121 per work hour, excluding taxes and mandatory

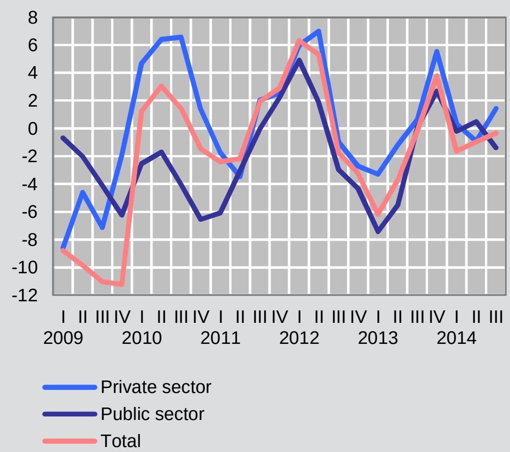
Chart IV.6.1 **Real net wages**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Real net wage growth in Q3 was driven by the private sector wage growth.

Chart IV.6.2 **Real net wages**
(y-o-y growth, in %)

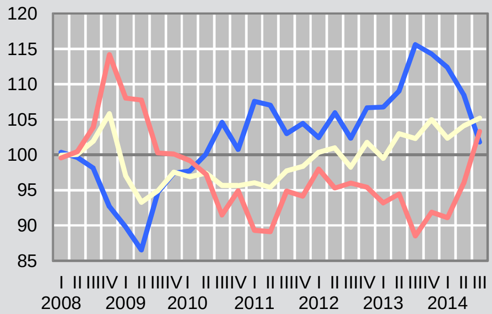


Sources: SORS and NBS calculation.

In Q3, real net wage in the private sector also grew in y-o-y terms, while the public sector saw a decline.

[32] H1 2008.

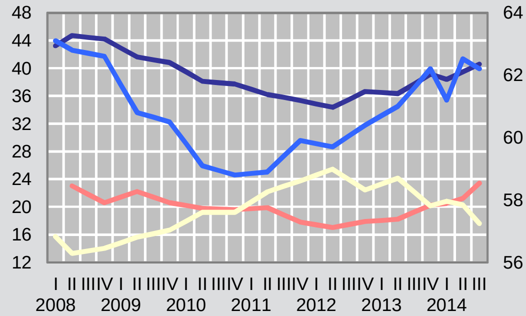
Chart IV.6.3 **Movements in productivity, real gross wages and unit labour costs in industry**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Recording a strong growth over the last two quarters, unit labour costs in industry surpassed their pre-crisis level in Q3.

Chart IV.6.4 **Labour market indicators under the Labour Force Survey**
(in %)



Source: SORS.

A drop in the unemployment rate in Q3 is largely attributable to the growth of informal employment.

social insurance contributions. The decision shall come into effect on 1 January 2015, which will push the minimum monthly wage up by 5.2%.

Lower productivity coupled with real wage growth drove **unit labour costs** in the overall industry up by 7.8% s-a in Q3, above their pre-crisis level. However, lower labour productivity in industry is mainly induced by floods, and is therefore temporary in nature. Unit labour costs grew less pronouncedly in manufacturing (3.7% s-a), as this sector of industry was the least affected by the floods.

Employment

Q3 saw a marked improvement in labour market indicators estimated based on the **Labour Force Survey** data. The unemployment rate edged down by as much as 2.7 pp from a quarter earlier to 17.6%, its record low since 2010. The employment rate went up by 1.1 pp to 40.6%, owing to a rise in informal employment, while the number of the formally employed even dropped slightly. The participation rate was mildly lower in Q3 (62.2%) compared to Q2, while marching in place y-o-y.

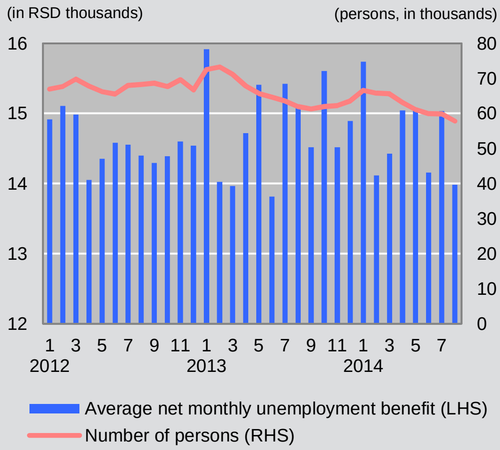
Labour market data obtained from the Survey do not capture real sector trends, given that the last two quarters witnessed a significant fall in economic activity. The employment increase can be mainly put down to seasonal, temporary and definite term employment, as confirmed by the fact that employment figures soared the most in agriculture, construction and activities of households as employers. In addition, higher number of employees in construction may have resulted from the engagement of additional workforce on flood remediation. On the other hand, sectors of the economy which have a significant share in value added creation (manufacturing, information and communications and transport) reported a decline in employment figures.

The greatest addition to employment came from part-time workers, while the number of those employed full-time slightly increased. After rising in Q2, the share of the long-term unemployed in total unemployed population edged down by 2.7 pp to 67.0% in Q3. Another positive signal is that unemployment of youth (aged 15–24) dropped by a marked 11.1 pp to 41.7% in Q3.

According to the estimate of the **Serbian Statistical Office**[33], formal employment dropped by 3,813 in Q3. The number of employed in the public sector continued to dwindle (by 3,694 persons), and the private sector followed suit (by 119 persons), thus reversing the trend from Q2. The number of employed shrunk across the

[33] RAD research.

Chart IV.6.5 **Average monthly unemployment benefit**



Source: National Employment Service.

The number of beneficiaries of the unemployment benefit continued to go down in Q3.

Table IV.6.1 **Employment and unemployment trends** (in thousands)

	2013	2014		
	Q4	Q1	Q2	Q3
Formal employment	**1,703.3**	**1,690.4**	**1,690.3**	**1,686.5**
Private sector	1,212.2	1,201.4	1,201.8	1,201.7
Public sector	491.1	489.1	488.5	484.8
Farmers (according to LFS)	**450.8**	**423.4**	**449.9**	**454.2**
Total employment	**2,154.1**	**2,113.9**	**2,140.2**	**2,140.7**
Total unemployment	**769.5**	**790.5**	**773.4**	**748.5**
First time job seekers	267.1	271.1	264.9	261.4
Workers with previous job experience	502.4	519.4	508.4	487.2

Sources: SORS and National Employment Service.

majority of sectors, except in manufacturing, trade, transport and construction, which is somewhat at variance with the Survey results.

The **National Employment Service** data also confirm a continued decrease in the unemployment figure in Q3 – down by 24,820 persons from June it came to 748,549 persons in September. A greater reduction in unemployment was recorded for workers with previous job experience (21,257 persons) relative to first time job seekers (3,563 persons). Unemployment also decreased in majority of professions, mainly in mechanical engineering and metal processing, textiles, leather industry, trade, catering and tourism. On the other hand, the number of unemployed increased in the health sector, pharmacy and social protection, which can be attributed to public sector employment ban in place since the beginning of the year.

The number of beneficiaries of the unemployment benefit has been on a constant decline since January. Thanks to this, a smaller share of the budget earmarked for labour market incentives is spent for passive employment measures and a larger share remains for active measures (training and retraining, public construction works etc.), which tackle unemployment more effectively.

7. International environment

Weaker economic performance in H1 and the persistent risks of deflation and tightening of economic relations with Russia prompted a downward revision of the euro area's GDP growth for 2014. The US economic growth in Q2 exceeded expectations, and an increasing number of signals point to its sustainability.

As the disinflationary pressures continued to sweep across the euro area in Q3, the ECB increased its monetary accommodation further, causing the euro to weaken against the dollar. At the same time, the Fed proceeded with QE tapering and hinted that interest rates could rise in 2015.

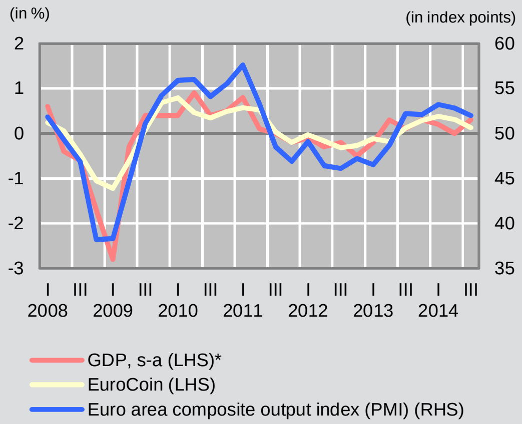
The international prices of most primary commodities declined in Q3, in response to the slowing pace of global economic growth.

Economic activity

The euro area economy was practically stagnant in Q2 (0.1% s-a growth). Germany and Italy suffered economic contraction (0.2% s-a each), while France experienced stagnation. Still, the leading indicator PMI Composite[34] suggests that the stagnation is temporary and that the economy may be expected to rebound in Q3. This is also

[34] For the fifteenth month in a row, PMI Composite indicated expansion (above 50 points).

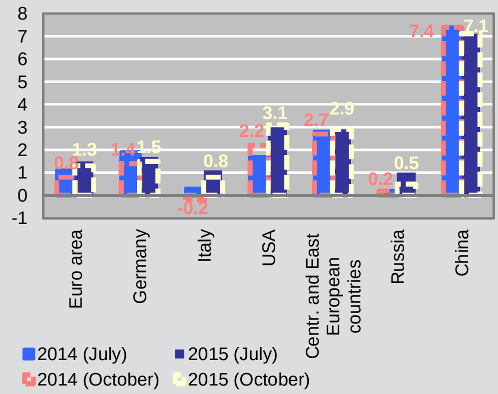
Chart IV.7.1 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)



Sources: Eurostat, Markit Group and Banca d'Italia.
* Consensus Forecast estimate for Q3 2014.

Leading indicators point to the recovery of economic activity in the euro area in Q3.

Chart IV.7.2 **Revisions of real GDP growth forecasts for 2014 and 2015 by the IMF***
(in %)



Sources: IMF WEO Update (July 2014) and IMF WEO (October 2014).
* Revision compared to July WEO Update.

The latest IMF projections point to slowing growth in the euro area and Russia and to a pick-up in the United States.

supported by Consensus Forecast, which envisages the euro area to grow in Q3 by 0.3% s-a.

Dampened economic activity in Germany in Q2 came as a consequence of reduced external demand, weighed down by the slowing pace of global growth and continuing geopolitical tensions in Ukraine and the Middle East. Global uncertainties also exerted downward pressure on investment, given the evidently increased cautiousness in the decision-making of businesses. In Q3, a slight pick-up is expected in the sector of services, while production sectors are poised for a decline due to weaker demand in the main export markets.

France suffered further economic stagnation in Q2, along with a fall in investment and net exports and a rise in private consumption. Similar trends are expected in the coming quarter, given that the leading indicator for the production sector is in the zone of recession[35]. Similar to Germany, Italy experienced a fall in economic activity as a result of reduced export demand, while domestic demand remained constrained by the high unemployment rate and the need for fiscal austerity. Spain is the only larger euro area economy that registered growth in Q2 thanks to the positive contribution of net exports. Based on leading indicators, this trend will continue in the coming quarter as well.

Downside risks to the euro area economy persist. They relate primarily to possible deflation and further tightening of economic relations with Russia. Because of these risks, the IMF trimmed its projection for the euro area growth by 0.3 pp to 0.8% in 2014 and by 0.2 pp to 1.3% in 2015. These projections are similar to those released by Consensus Forecast. The situation in the labour market should not be expected to improve any time soon given the sluggish economic growth and the need for additional structural reforms. This view is also supported by the unemployment rate, which remained unchanged in September relative to June (11.5%).

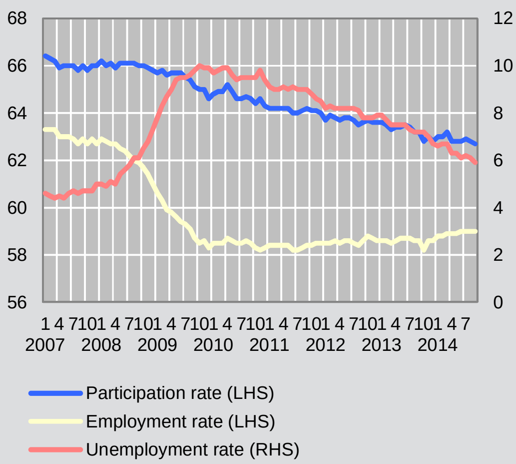
In October, the ECB disclosed the results of stress testing and asset quality review which covered 130 largest banks operating in the euro area. The results revealed that 25 banks failed the test and had a capital shortfall of EUR 25 bln. However, 12 banks have already raised EUR 15 bln during the year. These results have been assessed positively by the financial market and should help increase confidence in the euro area financial system and bolster credit activity.

According the October Consensus Forecast, **Central and East Europe** will grow 1.4% in 2014, which is 0.1 less than projected in July. The IMF is more optimistic in forecasting the region's economy to expand by 2.7%[36].

[35] Below 50 points.

[36] The difference stems from the different scope of coverage. The IMF's estimate does not include Russia, Ukraine and euro area members (Estonia, Latvia, Slovenia and Slovakia) and does include Turkey.

Chart IV.7.3 **US labour market**
(monthly rates, in %)



Source: Bureau of Labor Statistics.

The US unemployment rate fell in September to its lowest level since the outbreak of the financial crisis.

Central European countries with a more stable economic environment are estimated to have brighter growth prospects, while South-East European countries are likely to see slower growth. Growth is expected to accelerate significantly in Hungary, Poland and Czech Republic on account of past accommodative monetary policy measures. On the other hand, Turkey's growth is set to soften from the previous year due to the monetary tightening implemented in January in order to quell strong depreciation pressures.

Geopolitical tensions in Ukraine continue to reflect negatively on economic activity in Ukraine and Russia. The IMF and Consensus Forecast scaled down their projections for Russia yet another time – in 2014 they foresee stagnation and in 2015 around 1% growth due to strained access to funding, capital outflows and depreciation pressures. Growth forecast for Ukraine was also lowered (-6.5%). Even though the IMF approved a USD 17 bln loan to Ukraine, it will most probably need additional external funding.

The **US economy** rebounded strongly in Q2 (1.1% s-a), offsetting the consequences of an unexpected dip in Q1. The rebound was powered by private consumption and investment, while net external demand provided a negative contribution because of a vigorous rise in imports. Flash estimates indicate that the growth softened in Q3 to 0.9% s-a and is still led by private consumption and investment. Leading indicators suggest that the US economy will continue to grow until the end of the year – ISM Manufacturing was in the zone of expansion in October for the seventeenth month in a row, reaching 59.0 points, while Consumer Confidence Index resumed growth following a fall in September.

The results observed in the US labour market in Q3 are the best since the outbreak of the financial crisis. The unemployment rate fell to 5.8% in October, its lowest level since July 2008, while non-farm payroll employment maintained its high average growth rate of over 220,000 per month in Q3. Solid economic movements in Q2 and positive expectations for Q3 prompted the IMF to increase its growth forecast for the US economy in 2014 by 0.5 pp, to 2.2%, which is consistent with the October Consensus Forecast.

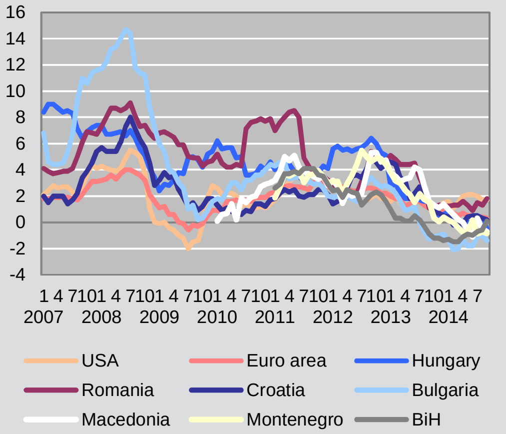
China's economic growth slackened from 7.5% in Q2 to 7.3% y-o-y in Q3. Q-o-q, growth measured 1.9% s-a and was driven by industrial production. PMI Manufacturing continued to move above 50 points in October, heralding further expansion of the industrial sector. Owing to the government's fiscal measures supporting infrastructure projects and SMEs, China's economic growth will be sustained above 7% in the coming period as well.

Inflation movements

The **euro area** inflation continued down in Q3. It measured 0.3% y-o-y in September, which is 0.2 pp less than in June. Strong disinflation is mainly attributable to the drop in energy prices, caused by the sharp fall in global oil prices. Medium-term inflation expectations measured as the spread between nominal and inflation-indexed securities slid to 1.9% in October, i.e. below the ECB's target of below, but close to, 2%. Still, ECB officials think that the accommodative monetary policy measures taken and announced, along with the euro's weakening vis-à-vis the dollar, will contribute to a moderate inflation rise in the coming period and its gradual return to the target. Based on preliminary estimates, the euro area inflation inched up in October to 0.4% y-o-y.

In most **Central and East European** countries, inflationary pressures were low in Q3 because of weak demand and falling energy prices. In addition to Bulgaria, which has been recording deflation for thirteen consecutive months, a y-o-y fall in inflation in September was registered in Hungary, Poland, Slovakia and Slovenia. On the other hand, depreciation of the lira early in the year generated inflationary pressures in Turkey, even though y-o-y inflation recorded a decline in September (9.0%) relative to June (9.2%).

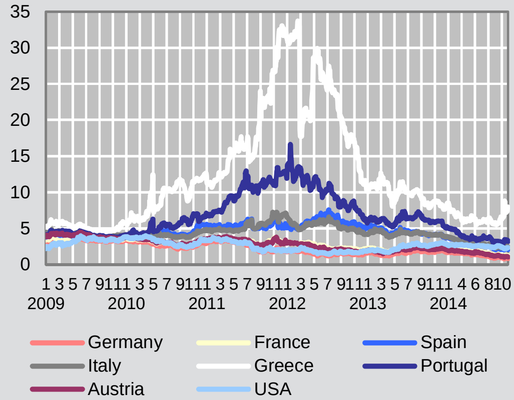
Chart IV.7.4 **CPI across selected countries**
(y-o-y rates, in %)



Sources: Eurostat, Bureau of Labor Statistics and statistical offices of selected countries.

Low inflationary pressures in the euro area and South East Europe continued in Q3.

Chart IV.7.5 **Yield on 10-year bonds of euro area members**
(daily data, in %)



Source: Bloomberg.

The yields on bonds of the above euro area members continued to fall in Q3. In October, however, the yields on Greek bonds recorded a rise amid a political crisis.

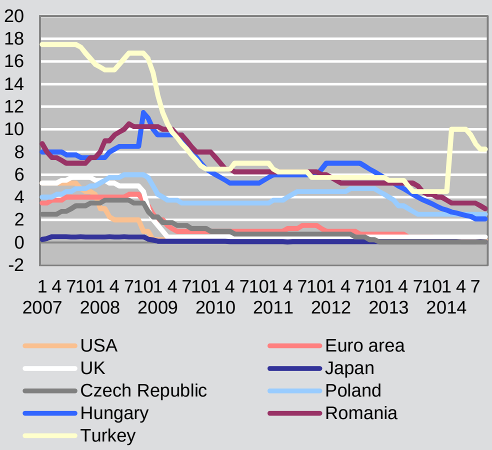
Lower inflationary pressures in Q3 were also observed in the **United States** – y-o-y inflation receded from 2.1% in June to 1.7% in September, in response to falling energy prices, notably those of gasoline. Inflation expectations remain firmly anchored, and the IMF's inflation projection of 2.0% in 2014 and 2.1% in 2015 is consistent with the Fed's long-term target.

Monetary policy

Persistently strong disinflationary pressures in the euro area prompted the **ECB** to ease its monetary policy further in Q3. The main refinancing rate was cut by additional 10 bp, to 0.05%, and the deposit facility rate to -0.2%. Furthermore, the ECB confirmed its earlier decision to start from Q4 with the purchases of asset-backed securities and the new programme of buying covered bonds that will last minimum two years with a view to bolstering credit activity. The first targeted LTROs were implemented in September – bank demand for liquidity amounted to EUR 82.6 bln, which is considerably below market expectations (EUR 150 bln).

Some central banks in the **region of Central and East Europe** proceeded with monetary policy easing in Q3. The central banks of Romania and Turkey lowered their policy rates by 50 bp each, while the central bank of Hungary trimmed its rate by 20 bp, pledging to keep it unchanged until 2016. On the other hand, geopolitical

Chart IV.7.6 **Policy rates across selected countries**
(monthly rates , in %)



Sources: Central banks of selected countries.

Monetary easing in the EU and Turkey proceeded in Q3.

tensions in Ukraine continue to send pressure on the foreign exchange markets of Russia and Ukraine, which is why their central bank responded by raising their policy rates by 50 bp and 300 bp, respectively. The central bank of Poland lowered its policy rate by 50 bp in October as the country's economic growth slowed down and y-o-y inflation plunged below zero. The Russian monetary authorities increased the policy rate in October by 150 bp in a bid to stave off persistent depreciation pressures.

At its September meeting, the **Fed** assessed that the US economic recovery was sustainable and conducive to further improvement in the labour market. Consistent with this assessment, the Fed decided to continue reducing its monthly purchases of US Treasury notes and mortgage-backed securities to USD 15 bln as of October. Judging that economic activity was recovering at a moderate pace and that the labour market conditions were improving, the Fed decided in its October meeting to end the bond-buying programme and to keep the main interest rate unchanged. The markets expect the Fed will start raising its main interest rate in the course of 2015.

Financial and commodity markets

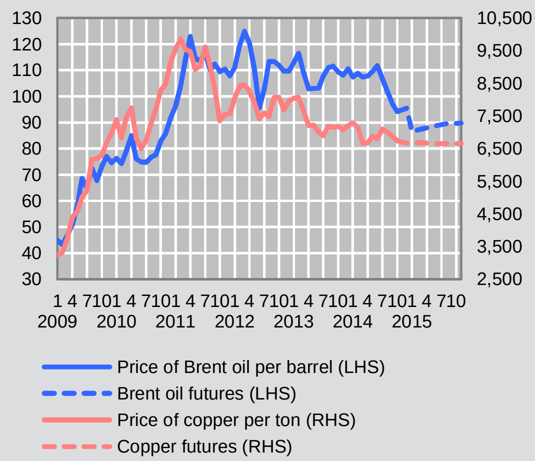
Divergent monetary policies pursued by the Fed and the ECB resulted in a steady weakening of the euro against the dollar in Q3. End-of-period, the euro depreciated against the dollar by 7.0%. The main drivers of the dollar's rise were favourable macroeconomic indicators in the United States, which suggested that the Fed might start monetary tightening earlier than expected. At the same time, the euro marked losses also due to the lowering of the ECB's main refinancing rate and announcement of the use of additional instruments to increase liquidity in the euro area.

Standard & Poor's raised the Greek sovereign rating from B- to B and maintained stable outlook, citing progress in fiscal consolidation and the Greek government's resolve to continue with structural and institutional reforms. Croatia, on the other hand, received in August a credit rating downgrade from Fitch (from BB+ to BB and outlook changed from negative to stable) amid concerns over the capacity to stabilise high public debt in the medium term.

At end-September, the price of gold was by 8.3% lower than at end-June. In the first half of July, gold prices rose on the back of mounting tensions in the Middle East and Ukraine. From mid-July, however, they reversed the trend and declined all the way until end-Q3. The downward trend in gold prices can be put down mainly to the fall in demand following the release of positive macroeconomic indicators for the US economy.

Brent oil prices were on the decline throughout Q3. At end-September, they were by 16.9% lower than at end-

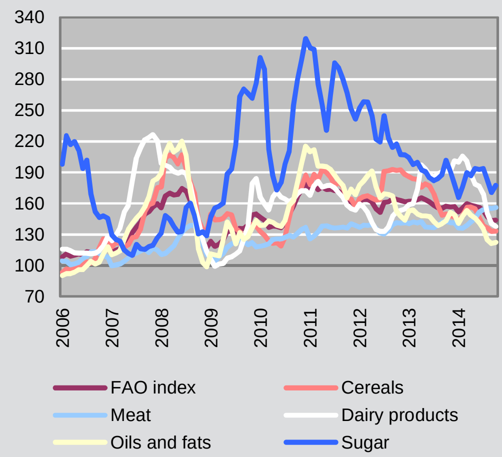
Chart IV.7.7 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

The fall in oil and copper prices in Q3 can be put down to reduced demand which fell victim to the slowing pace of global growth and stronger dollar.

Chart IV.7.8 **World food price index**
(in real terms, 2002−2004 = 100)



Source: FAO, UN.

Good production results in the new agricultural season led to a further fall in world food prices in Q3.

June. The decline was triggered by global macroeconomic indicators which pointed to slower-than-expected recovery and lower demand for oil. At the same time, oil supply increased as a result of renewed oil exports from Libya and higher output in Saudi Arabia and the United States. The fall in oil prices was also aided by the strengthening of the dollar against the world's other major currencies. Had it not been for the continuing geopolitical tensions in Ukraine and the Middle East, the fall in oil prices in Q3 would have been even sharper.

International copper prices exhibited occasional volatility in the course of Q3 and ended September 3.1% lower than at end-June. Their fall was precipitated by the indicators which signalled the slowing of the economic growth of China, the world's largest importer of copper. Further impetus to the fall in copper prices came also from the dollar's rise.

The fall in world food prices, measured by the FAO index, stepped up in Q3. At end-September, world food prices were by 8.3% lower than at end-June. In fact, they reached their lowest level since August 2010. Good production results and high export supplies contributed to the drop in cereal prices, and a similar thing happened with the prices of sugar and vegetable oil. In addition to increased supply, the fall in dairy prices was also due to the Russian embargo on the imports of milk from the EU. The only component of the FAO index that recorded growth in Q3 was the price of meat which hit its historical high in September. The price of meat rose as a result of reduced cattle supply from Australia and the still low supply of pork after the PED virus in the States.

V. Inflation projection

Y-o-y inflation is expected to stay below the lower bound of the target in the current and the coming quarter, possibly re-entering the target tolerance band temporarily in November. Inflation will return within the target tolerance band in the course of the next year under the impact of administered and food prices, and to a certain degree, under the impact of the dinar's weakening in Q3. Working in the opposite direction will be low aggregate demand, whose disinflationary impact will be reinforced by fiscal consolidation measures. The risks to the projected inflation path are associated primarily with fiscal movements, administered prices, and the impact of developments in the international environment on domestic economic and financial flows and on the prices of primary commodities.

Due to the negative impact of the May flooding on the energy and mining sectors and the slowing growth of Serbia's key trade partners, our GDP will contract this year, and most probably next year as well having in mind additional fiscal consolidation measures.

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

Consistent with the expectations stated in the August *Report*, y-o-y inflation continued to move below the lower bound of the target tolerance band in Q3 (2.5%) and amounted to 2.1% in September. Core inflation (CPI excluding food, energy, alcohol and cigarettes) has been running below the lower bound of the target since August as well. Low inflationary pressures reflected weak aggregate demand, stable inflation expectations and the absence of major cost-push pressures in the production of food and pressures from import prices.

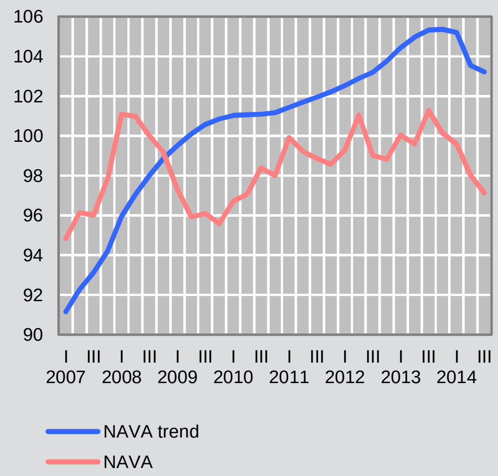
Looking at CPI components, the seven-month target undershooting is due primarily to food prices which declined amid a fall in the international and local prices of primary agricultural commodities in place since mid-May. In addition to this, administered price growth turned out to be rather low compared to the previous years. Namely, in the first nine months of the year, it measured mere 2.6%, largely owing to the absence of electricity price adjustment.

As the seasonal decrease in prices of food, notably fruit and vegetables, failed to come about, consumer prices recorded a marginally stronger q-o-q growth in Q3 than anticipated in the previous Report (0.3% vs. 0.0%).

One year-ahead inflation expectations of the financial sector were stable in Q3 and continued to revolve around the target. Following a rise in July, inflation expectations of businesses returned to the target in August where they have remained since. Two year-ahead inflation expectations of both sectors are on the target as well.

From July to October, the dinar was under depreciation pressures stemming from global factors (geopolitical tensions, continued QE tapering by the Fed, sluggish recovery of the euro area) and unfavourable news regarding the pace and scope of fiscal consolidation and structural reforms, which led to a modest capital inflow. Even though the country risk premium, measured by EMBI, recorded growth on two occasions, at end-October it was almost the same as at end-June (270 bp). In the same period, the NBS intervened in the IFEM by selling EUR 365.0 mln net.

Chart V.0.1 **Output gap**
(Q3 2008 = 100)



Sources: SORS and NBS calculation.

Output gap widended in Q3 relative to Q2.

In the year to September, consolidated budget deficit (including below-the-line expenses) amounted to 5.6% of GDP. Of this amount, 3.2 pp related to interest payments. In late October, a revised budget was adopted, envisaging a cut in pensions and public sector wages beginning from November. According to our estimates, consolidated budget deficit (including below-the-line expenses) will amount to around 7.5% of GDP this year. Budget outlook for the coming period will depend on the pace and scope of fiscal consolidation, as well as on the dynamics and method of financing the works to restore flood damage.

Based on NBS estimates, GDP contracted in Q3 by 1.0% s-a, driven chiefly by the sharp downturn in industrial output precipitated by the flood damage to the sectors of energy and mining. The production of motor vehicles also slumped in Q3. On the expenditure side, the largest negative contribution is expected from net exports, given that automobile industry and agricultural product exports decreased and energy imports increased. The rise in real imports was also powered by the fall in import prices (food and oil).

Output gap[37] is estimated to have widened in Q3 relative to Q2 because of a fall in NAVA. The size of the output gap indicates that the disinflationary pressures generated by aggregate demand will remain strong in the medium term. It should be noted that these pressures will be only reinforced by the implementation of fiscal consolidation measures.

The international prices of most primary commodities declined in Q3 as a consequence of the slowing pace of global economic growth. Brent oil prices, for instance, were by more than 15% lower at end-Q3 than at end-Q2. The decline was precipitated, inter alia, by increased oil supply (from Libya, Saudi Arabia and the United States) and the strengthening of the dollar, while continuing geopolitical tensions in Ukraine and the Middle East helped avert an even sharper fall.

After practically stagnating in Q2 (0.1% s-a growth), economic activity of the euro area seems to have picked up slightly in Q3 based on PMI Composite[38] and Consensus Forecast (0.3% s-a according to Consensus Forecast). However, as the risk of a too-prolonged period of low inflation persisted, the ECB decided in September to slash the main refinancing rate to its historical low (0.05%) and to cut further the negative interest rate on deposit facilities (-0.2%). In addition to implementing targeted LTROs, the ECB confirmed it would start in Q4 with the purchases of asset-backed securities and covered bonds. By contrast to the ECB, the Fed made a decision in its October meeting to end the asset purchase programme.

Inflation projection assumptions

External assumptions

The assumptions for the euro area's GDP growth in 2014 and 2015 have been slightly revised from the August projection – to 0.8% and 1.2%[39], respectively. Domestic demand in the euro area should be supported by monetary policy measures and improvement in financial conditions, while a positive effect on the economy should also come from progress in fiscal consolidation and structural reforms and the recovery of demand for exports.

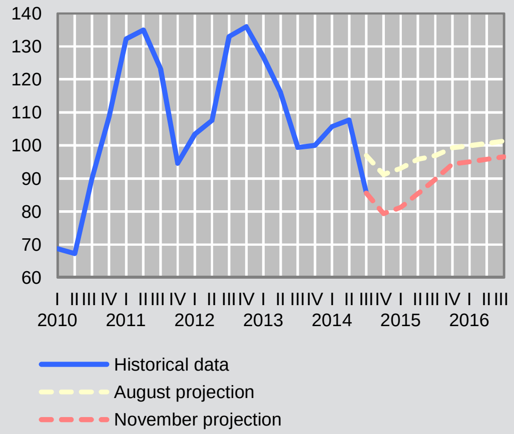
The euro area inflation plunged to its five-year low in September (0.3% y-o-y), well below the ECB's target of just under but close to 2.0%. Medium-term inflation expectations also fell below the target. According to Consensus Forecast, the markets expect no change in the ECB's main refinancing rate in the coming twelve months.

[37] 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 potential output.

[38] In September, this indicator was in the zone of expansion (above 50 points) for the fifteenth month in a row.

[39] The assumption for the euro area's GDP growth in 2014 and 2015 is consistent with the latest Consensus Forecast.

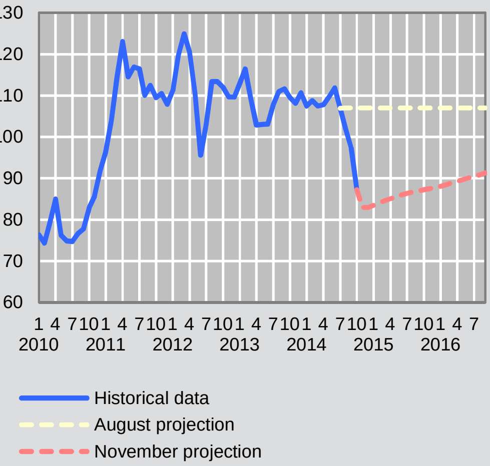
Chart V.0.2 **Assumption for international prices of primary agricultural commodities**
(Q4 2013=100)



Sources: BSE, CBOT and NBS.

The assumption for international prices of primary commodities has been revised down.

Chart V.0.3 **Assumption for Brent oil prices**
(USD/barrel)



Sources: Bloomberg and NBS.

The assumption for global oil prices has been revised down.

The movements of primary agricultural commodity prices internationally have a decisive impact on the movements of these prices locally. Consistent with the steep fall in these prices in the international market (around 30% in the last six months[40]), the projection assumes they will be much lower than envisaged by the previous projection. Their fall is attributable to the globally good agricultural season and is probably aided by the considerable strengthening of the dollar since early May. We expect the prices of primary agricultural commodities to rise next year slightly more than indicated by the current commodity futures (7.5%). The reason for being conservative in our projection is a very good agricultural season this year which makes the prices and hence, this year's base relatively low.

Given the current oil price movements[41], we have scaled down our assumptions for oil prices significantly relative to the August projection. Until the end of this year, oil prices are expected to stay close to their current level (USD 83.0 per barrel), whereas in 2015 they are assumed to rise moderately, given the oil futures and the expected moderate acceleration in global economic growth.

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

	2014		2015	
External assumptions				
EU inflation (Q4 to Q4)	0.6%	(-0.4)	1.1%	(-0.2)
ECB policy rate (year-end)	0.05%	(-0.1)	0.05%	(-0.1)
Euro area GDP growth	0.8%	(-0.3)	1.2%	(-0.4)
International prices of primary agricult. commodities (Q4 to Q4)*	-24.0%	(-16.0)	19.0%	(+11.0)
Brent oil price per barrel (year-end, USD)	83.0	(-24.0)	88.0	(-19.0)
Internal assumptions				
Administered prices (Dec to Dec)	3.0%	(-6.5)	10.4%	(+2.1)
Trends				
Appreciation trend of the real exchange rate (average)	1.5%	(-0.1)	1.6%	(-0.1)
Real interest rate trend (average)	2.7%	(+0.2)	3.0%	(+0.1)

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

[40] Measured by the composite index which comprises the prices of wheat, corn and soybean as the most important inputs to the domestic food production.

[41] Brent.

Internal assumptions

Consistent with the expected movements in international prices of primary agricultural commodities, the projection assumes their local counterparts will also fall this year (though somewhat less than the international prices due to the dinar's recent losses against the dollar) and rise in the next year.

In 2014, administered prices should mark the smallest increase since CPI records began – around 3.0%. The reason for such a small increase lies in the fact that there was no adjustment in electricity prices this year. We were cautious in the August projection and assumed a 15.0% increase in electricity prices in Q4 even though there were no official confirmations of such a move. In light of the latest announcements from the Government, this projection envisages the said increase to take place in April 2015. As a result, total administered price growth in 2015 is expected to become double digit again (around 10.0%).

Another assumption underlying the projection is the appreciation trend of the real exchange rate typical for transition countries and conditioned by the removal of price disparities, mainly in the area of administered prices. This trend is slightly slower than in the August projection because of the downward revision of potential domestic GDP growth and a smaller-than-anticipated administered price growth.

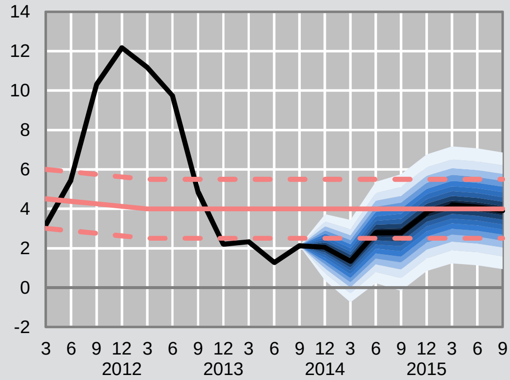
We have also assumed, consistent with the announcements from the Government, fiscal consolidation in the coming period that will put public finance on a sustainable footing. The reduction of pensions and public sector wages being the first step in that direction, we assume the adoption of other measures too that will stabilise public debt until 2017 and then send it on a downward path. The projection also envisages that a new arrangement will be agreed with the IMF.

Projection

Inflation projection

Under the central projection, y-o-y inflation will stay below the lower bound of the target in the current and the coming quarter, possibly re-entering the target tolerance band temporarily in November (partly because of the low base). From Q2 2015, y-o-y inflation is expected to resume growth and return within the target tolerance band (4.0±1.5%) around mid-year. It is expected to trend closer to the target until end-2015 and continue revolving around the target over the remainder of the forecast period.

Chart V.0.4 **Inflation projection**
(y-o-y, in %)



Source: NBS.

Y-o-y inflation is expected to rise in 2015 and reach the target by the end of that year. After that it is expected to move around the target.

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%.

While in the August Report we expected y-o-y inflation to return within the target tolerance band in Q4, our estimates now suggest that this is possible in November, though only on a temporary basis. The effect of low last year's base and the past weakening of the dinar on inflation will be probably offset by the low demand and a sharp fall in primary agricultural commodity prices in the last six months.

Inflation's return to the target in 2015 will be driven primarily by administered prices. The upward revision of electricity prices has been announced for April 2015, which means that the y-o-y administered price growth will gather pace from that month on. Even though their contribution to inflation in 2015 would not differ much from those in previous years (around 2 pp), administered prices are expected to be the main driving force behind inflation growth next year. Another important contributor to CPI growth next year will be prices of food, though their contribution will be significantly lower than that of administered prices.

Looking at food prices, the decisive impact on inflation movements in the coming period will be exerted by fruit and vegetable prices, whose y-o-y growth could easily enter double digits until the new agricultural season sets in. Other food prices, by contrast, will be probably on the decline. Though the prices of primary agricultural commodities (soybean, wheat and corn) are likely to go up in 2015 in both local and international markets, the costs of raw materials in the production of food may be reasonably expected to stay low given the significant decline in those prices in the last six months (around 25% in the local and around 30% in the international market).

The weakening of the dinar since July could put pressure on prices, notably those of imported products and non-food products with considerable import content. Still, the intensity of this pressure will depend on the importers/producers' ability to command higher prices against the backdrop of depressed domestic demand. An alternative would be, for those who can, to lower their margins. The pressure on import prices in Serbia should be additionally constrained by the very low inflation abroad, especially in the euro area as our key trade partner.

Low domestic demand continues to be the main disinflationary factor in both short and medium term. The disinflationary effect of this factor will be reinforced by the fiscal consolidation measures that will weigh down on government and household consumption. The disinflationary effect of domestic demand could be moderated to a degree by the increase in external demand if the euro area continues to recover, as well as if the depreciation of the dinar leads to improved price competitiveness of our exports.

The movement of inflation expectations shows that their effect on inflation remains neutral. A positive signal in this context is that the two year-ahead inflation expectations are on the target (4.0%) and lower than those for one year ahead (4.5%).

The risks to the projected inflation path are associated primarily with fiscal movements, administered prices, and developments in the international environment, including prices of primary commodities.

At this point, the international environment is plagued primarily by uncertainties over the effects of normalisation of the US monetary policy on the financial markets, further evolution of the geopolitical situation and the pace of recovery of the euro area.

Table V.0.2 **Projections of key macroeconomic indicators for Serbia**

	2014		2015	
	Previous	New	Previous	New
Inflation (annual average, in %)				
IMF	4.0	2.3	4.0	3.4
European Commission	3.8	2.2	4.5	3.5
Consensus Forecast	3.1	3.0	4.6	4.6
GDP (%)				
IMF	10	-0.5	15	10
European Commission	11	-10	19	0.0
Consensus Forecast	0.8	-0.5	2.1	15
Current account deficit (% of GDP)				
IMF	4.8	6.1	4.6	5.1
European Commission	4.6	5.4	4.3	4.8
Consensus Forecast*	5.2	5.1	5.3	4.9

Sources: IMF WEO (April and October 2014), European Commission (Spring forecast 2014 and Autumn forecast 2014) and Consensus Forecast (July and October 2014).

* Calculated based on the NBS projection of dollar GDP in August and November 2014.

Given the current geopolitical tensions and the normalisation of the Fed's monetary policy, capital flows to emerging market economies, Serbia included, are likely to be more volatile in the coming period. A potential increase in investor risk aversion in the global financial markets would probably dampen capital inflows, perpetuate depreciation and consequently, put pressures on domestic prices.

If, despite monetary stimulus from the ECB, the euro area recovery turns out to be slower than expected because of potential further tightening of geopolitical tensions (notably the crisis in Ukraine), Serbia's negative output gap could widen, leading to stronger disinflationary pressures from aggregate demand. Besides, further deleveraging of euro area banks could deal a strong blow to the domestic credit activity. Good news, however, is that even though among banks identified to have a capital shortfall by the ECB in the latest stress testing there were a few banks with subsidiaries in Serbia, but given the recapitalisation and adoption (approval) of resolution plans, these banks actually have a negligible or no capital shortfall at all.

In a situation where external sources of funding are a necessity, the efforts to reduce fiscal imbalance gain critical importance. This year's budget revenue will be tamped down by the slack in economic activity and by the probable increase in the shadow economy[42], while government expenditure will be additionally burdened by the need to restore flood damage. Nevertheless, from the aspect of public finance sustainability, the implementation of fiscal adjustment measures should start as soon as possible in order to boost the resilience of the domestic economy to potential external shocks.

While administered price growth is an assumption of the medium-term inflation projection, the lack of a transparent mechanism and dynamics of administered price revision makes the primary and secondary (through impact on other prices) effects of these revisions on inflation less predictable. Electricity prices represent the most important category within administered prices. If their increase, expected in April 2015, fails to come about or if the size of the increase deviates from the one assumed, the inflation outturn could depart from the projected path.

Any deviation of the actual from the assumed trajectory of primary agricultural commodity prices in the international and local market in the coming period could also steer inflation away from the projected path. Though deviations are possible in either direction, we think it is more likely that the growth in primary agricultural commodity prices in 2015 will be lower rather than higher relative to the growth assumed.

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

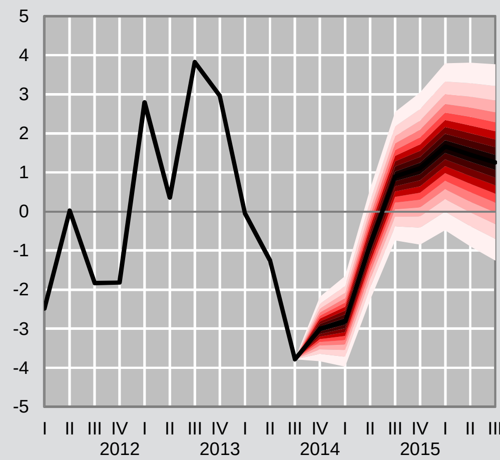
Looking ahead, monetary policy easing will depend on the effects of past monetary policy measures, the effects of fiscal consolidation measures and structural reforms, as well as on the assessment of the potential inflationary impact of developments in the international environment.

GDP projection

Due to the negative impact of the May flooding on the energy and mining sectors and the slowing growth of Serbia's key trade partners, our GDP will contract this year, and most probably next year as well having in mind additional fiscal consolidation measures.

The fall in GDP in 2014 will be driven mainly by the downturn in industrial production, the key drag being a flood-induced drop in mining and energy and, to a lesser extent, lower production in manufacturing. Furthermore, judging by the movement of relevant indicators, instead of growing as previously expected, construction is poised for a fall in the current year. On the other hand, available indicators suggest that agriculture will see a mild growth. On the expenditure side, the weakening of external demand over the past several months is likely to reverse the expectation of net exports' contribution to GDP – from positive to neutral. Negative contribution is anticipated from household consumption and private investment, while a positive contribution is expected from government investment.

Chart V.0.5 **GDP growth projection**
(y-o-y rates, in %)



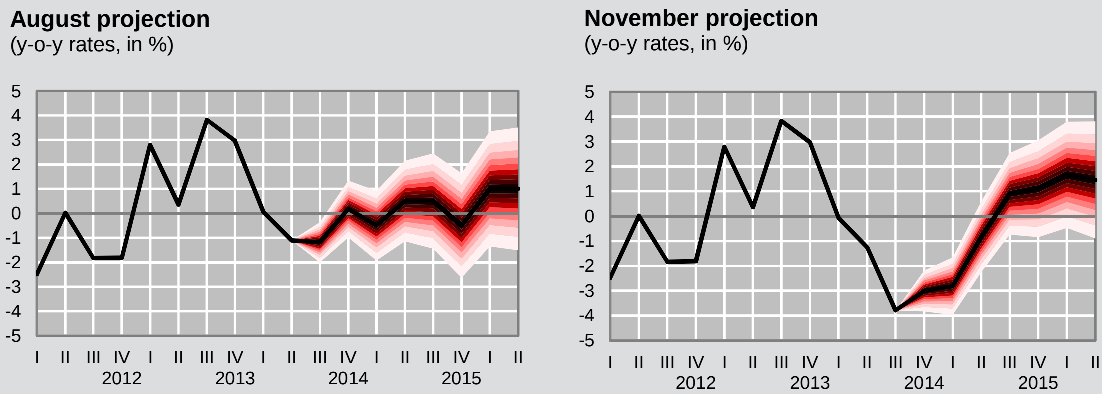
Source: NBS.

Economic activity will contract this year and most probably next year as well.

Household consumption is likely to shrink further next year, giving a somewhat higher negative contribution to GDP than in this year, given that public sector wage cuts will continue and that pensions will follow suit by the end of the year. Government consumption is also set for a fall. On the other hand, net exports and investments are still expected to provide a positive contribution next year and to largely offset the anticipated drop in final consumption. A positive boost from net exports should result from the recovery of the euro area and a contraction in imports due to the announced fiscal adjustment measures. However, given the deterioration in the euro area growth prospects for the next year, the contribution of net exports has been revised down from the August projection. Investments are likely to grow, thanks to the implementation of fiscal

[42] This is indicated by the significant underperformance revenue from excise duties on tobacco products this year.

Chart V.0.6 **Current vs. previous GDP growth projection**



Source: NBS.

While the August projection envisaged stagnation in 2015, this projection anticipates a decline.

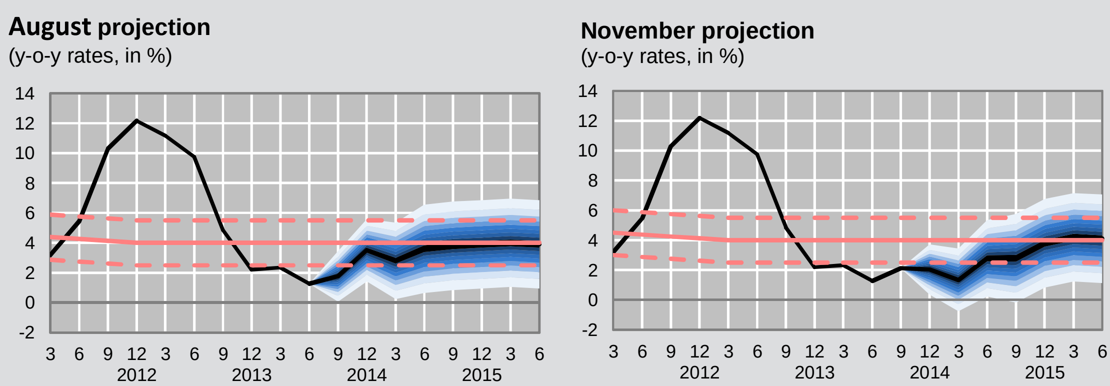
consolidation and structural reforms, but also as a result of efforts to restore the flood damage. On the production side, effort to restore the flood damage will lead to a sizeable positive contribution of construction, mining and energy to GDP in 2015.

Uncertainty regarding the achievement of GDP projection is associated mainly with the pace of economic recovery of the euro area, i.e. Serbia's main foreign trade partners, especially in case current geopolitical tensions escalate further and cause disruptions to global trade, energy or financial flows. Furthermore, depending on their pace and intensity, fiscal consolidation and structural reforms could exert a greater than expected short-term negative impact on GDP. Namely, in case fiscal consolidation and structural reforms turn out slower or weaker than initially announced, the country's risk premium and the depreciation pressures will probably rise, causing indirectly a sharper real fall in domestic consumption, while in the opposite scenario, GDP will be affected through a greater direct negative effect on domestic demand. One of the factors relevant for GDP projection is the dynamics of flood damage restoration, particularly in the fields of construction and energy, but this will depend on the availability of the sources of funding. The projection operates on the assumption that the energy security of the country will be maintained despite reduced capacities in the energy supply system. On balance, the risks to GDP projection are judged to be symmetric.

Comparison of projections and their outcome

Stronger than expected disinflationary pressures in Q3 and their likely persistence in the following two quarters have caused a delay in the inflation's return within the

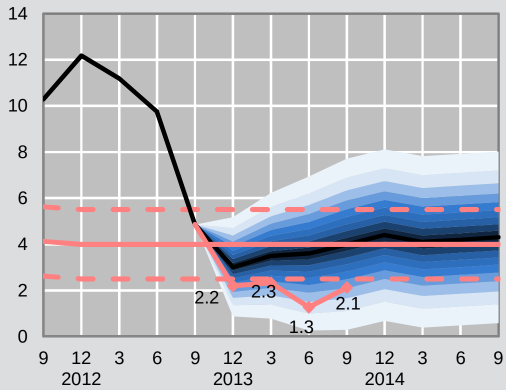
Chart V.0.7 **Current vs. previous inflation projection**



Source: NBS.

The new inflation projection is lower than the August projection.

Chart V.0.8 **Achievement of November 2013 inflation projection**
(y-o-y rates, in %)



Source: NBS.

In the last year, y-o-y inflation moved below the central projection from November 2013.

target tolerance band compared to the August projection – from Q4 2014 to Q2 2015. The main reason for the departure from the previous projection lies in the continued disinflationary pressures from the market of primary agricultural commodities and the absence of electricity price increase in the last quarter of this year. Inflation projection for 2016 has remained unchanged, and so has the medium-term projection band.

During the last year, y-o-y inflation was moving below the central projection from the November 2013 *Inflation Report.* Inflation deviated from the central projection under the impact of a smaller-than-anticipated increase in administered prices (1.4 pp lesser contribution to inflation), sharp fall in primary agricultural commodity prices[43], which further reduced the cost-push pressures in food production, and lower aggregate demand.

[43] Under the projection released in November 2013, these prices were to go up by around 15% with the onset of the agricultural season in 2014.

Table A
Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1 2014	Q2 2014	Q3 2014
EXTERNAL LIQUIDITY INDICATORS (in %)												
FX reserves/imports of goods and services (in months)	6.1	9.0	7.5	5.4	9.7	8.4	8.8	7.7	7.5	7.0	6.7	7.2
FX reserves/short-term debt	177.0	265.1	250.6	162.6	220.6	193.0	299.6	242.6	289.8	278.1	283.2	312.4
FX reserves /GDP	23.3	36.9	32.7	24.2	34.6	33.6	36.1	34.5	32.7	30.5	29.8	32.3
Debt repayment/GDP	5.0	10.3	10.3	10.7	12.8	12.0	12.4	13.1	13.2	12.7	13.2	10.2
Debt repayment/exports of goods and services	19.8	36.2	37.5	37.5	48.8	37.4	37.3	36.1	32.3	30.2	29.5	23.6
EXTERNAL SOLVENCY INDICATORS (in %)												
External debt/GDP	59.3	58.5	59.0	62.3	72.7	79.0	72.2	80.9	75.2	74.9	74.5	78.3
Short-term debt/GDP	13.2	13.9	13.1	14.9	15.7	17.4	12.0	14.2	11.3	11.0	10.5	10.3
External debt/exports of goods and services	234.9	205.7	214.2	219.1	277.0	246.9	216.4	223.0	184.5	177.9	172.5	182.5
FINANCIAL RISK EXPOSURE INDICATORS (in %)												
FX reserves/M1	290.3	356.1	306.7	300.4	393.4	416.6	429.6	402.1	330.4	335.3	293.1	220.2
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	199.9	192.8	191.8	199.8
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	70.8	77.4	80.2	82.6	69.0	79.8	82.7	89.9	92.7	94.1	101.0	97.7
MEMORANDUM: (in EUR million)												
GDP[1]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	7,882[2]	8,150[2]	8,528[2]
External debt	12,520	14,291	17,382	20,982	22,272	23,509	24,123	25,645	25,764	25,650	25,310	26,361
External debt servicing	1,054	2,513	3,039	3,594	3,922	3,564	4,154	4,147	4,510	998	1,078	872
Central bank foreign exchange reserves	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	10,428	10,125	10,878
Short-term debt[3]	951	968	1,044	1,832	1,843	1,752	601	455	197	141	155	129
Current account balance	-1,778	-2,356	-5,320	-7,135	-1,770	-2,082	-3,305	-3,640	-2,092	-502	-495	-504

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

Methodological notes:

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

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

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

Debt repayment/GDP (in %) - ratio of debt repayment (excluding early repayment of part of debt to the London Club creditors) to GDP during period under review.

Debt repayment/exports (in %) - ratio of debt repayment (excluding early repayment of part of debt to the London Club creditors) to exports of goods and services during period under review.

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

Short-term debt/GDP − ratio of end-of-period short-term debt at remaining maturity to GDP.

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

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

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

[1] According to the ESA 2010 methodology.

[2] NBS estimate.

[3] At original maturity.

Notes:

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

2. Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM5.

3. As of 1 January 2010 the Serbian Statistical Office applies the general trade system of registration of exports and impots which is a broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using the special trade system. Trade with Montenegro is registered within relevant transactions as of 2003.

4. In September 2010, the methodology of external debt statistics was changed – public sector external debt includes liabilities under SDR allocation (EUR 435.9 mln) used in December 2009. Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 844.4 mln, of which EUR 387.8 mln relates to domestic banks and EUR 456.6 mln to domestic enterprises).

5. External debt repayment does not include: short-term debt repayment and advance debt repayment.

Table B
Key macroeconomic indicators

	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1 2014	Q2 2014	Q3 2014
Real GDP growth (in %)[1)]	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1.0	2.6	0.1	-1.1	-3.7
Consumer prices (in %, relative to the same month a year earlier)[2)]	17.7	6.6	11.0	8.6	6.6	10.3	7.0	12.2	2.2	2.3	1.3	2.1
NBS foreign exchange reserves (in EUR million)	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	10,428	10,125	10,878
Exports (in EUR million)[3)]	5,329	6,948	8,114	9,577	8,041	9,521	11,147	11,498	13,963	3,304	3,655	3,700
- growth rate in % compared to a year earlier	19.1	30.4	-	18.0	-16.0	18.4	17.1	3.2	21.4	16.0	7.4	-5.8
Imports (in EUR million)[3)]	9,612	11,970	15,503	18,267	13,098	14,243	16,497	16,993	17,796	4,109	4,574	4,631
- growth rate in % compared to a year earlier	0.7	24.5	-	17.8	-28.3	8.7	15.8	3.0	4.7	2.5	4.6	1.3
Current account balance[3)]												
(in EUR million)	-1,778	-2,356	-5,320	-7,135	-1,770	-2,082	-3,305	-3,640	-2,092	-502	-495	-504
as % of GDP	-8.4	-9.6	-18.1	-21.2	-5.8	-7.0	-9.9	-11.5	-6.1	-6.4	-6.1	-5.9
Unemployment according to the Survey (in %)	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	20.8	20.3	17.6
Wages (average for the period, in EUR)	209.7	260.0	347.1	400.5	337.4	330.1	372.5	364.5	388.6	361.4	388.7	381.4
RS budget deficit/surplus	0.5	-1.7	-1.6	-1.9	-3.1	-3.3	-3.9	-5.4	-4.5	-7.9	-4.8	-2.3
Consolidated fiscal result (in % of GDP)	1.1	-1.4	-1.9	-2.6	-4.2	-4.5	-4.7	-6.1	-4.7	-7.1	-4.2	-3.2
RS public debt, (external + internal, in % of GDP)	50.2	35.9	29.9	28.3	32.8	41.8	45.4	56.2	59.6	60.6	61.2	67.5
RSD/USD exchange rate (average, in the period)	66.87	67.03	58.39	55.76	67.47	77.91	73.34	88.12	85.17	84.47	84.30	88.53
RSD/USD exchange rate (end of period)	72.22	59.98	53.73	62.90	66.73	79.28	80.87	86.18	83.13	83.89	84.85	93.62
RSD/EUR exchange rate (average, in the period)	82.99	84.11	79.96	81.44	93.95	103.04	101.95	113.13	113.14	115.75	115.58	117.37
RSD/EUR exchange rate (end of period)	85.50	79.00	79.24	88.60	95.89	105.50	104.64	113.72	114.64	115.38	115.79	118.85
MEMORANDUM: GDP (in EUR million)[4)]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	7,882[5)]	8,150[5)]	8,528[5)]

[1)] At constant prices of previous year.

[2)] Retail prices until 2006.

[3)] Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM5. Due to the interruption of the series for 2007, exports and imports growth rates are not shown. As of 1 January 2010, the Serbian Statistical Office applies the general trade system of registration of exports and imports, which is a broader concept and includes all goods entering/exiting the country's economic territory, apart from goods in transit. The Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using the special trade system. Trade with Montenegro is registered within relevant transactions as of 2003.

[4)] According to the ESA2010 methodology.

[5)] NBS estimate

Notes:

1. Data are subject to corrections in line with the official data sources.
2. Source for the data on unemployment: Labour Force Survey, Statistical Office
3. Source: MoF for public debt and NBS for estimated GDP.

Appendix 1. National Bank of Serbia's Letter to the Government of the Republic of Serbia on Reasons Why Inflation Departed from the Target

Belgrade, 12 September 2014

GOVERNMENT OF THE REPUBLIC OF SERBIA

Mr Aleksandar Vučić, Prime Minister

Dear Mr Vučić,

As inflation has been moving below the lower bound of the target tolerance band for six consecutive months, I am writing this letter in accordance with the Agreement on Inflation Targeting Between the National Bank of Serbia and the Government of the Republic of Serbia (Section 6, paragraph 4), adopted at the Government session of 19 December 2008, in order to explain why inflation has moved away from the target tolerance band, to describe the measures that will be taken with a view to maintaining inflation within the target tolerance band in the medium term, and to set out the period within which we expect inflation to return within the band.

From March to August 2014, year-on-year inflation was moving below the lower bound of the target tolerance band (4.0±1.5%), measuring 1.5% in August. The weakening of inflationary pressures in the prior period reflects the interplay of several factors, most of all the expectedly low aggregate demand, relatively stable movements in the foreign exchange market and reduced cost-push pressure on food prices. While the disinflationary effect of the first two factors was expected, the drop in food production costs was sharper than anticipated. Besides, the absence of adjustment of electricity prices in the last year also played a role in inflation undershooting.

From March to August 2014, year-on-year inflation averaged 1.9%. The contribution of food prices was negative and equalled 0.9 percentage points. As a result of good agricultural seasons in 2013 and 2014, international and domestic prices of primary agricultural commodities were lower than expected and their disinflationary effect on food prices proved stronger than assumed in our earlier projections.

The absence of adjustment of electricity prices, which was envisaged to take place in the third quarter, also played a part in continuous undershooting of the target tolerance band. In this context and in order to help stabilise year-on-year inflation rates, the National Bank of Serbia has addressed the Government of the Republic of Serbia and presented its proposal for the adjustment of electricity prices according to a pre-defined criterion in the same month each year.

The Executive Board of the National Bank of Serbia has taken all measures within its remit to bring inflation back within the target tolerance band in the medium run. The easing of monetary policy, which started back in May 2013, continued into 2014. From May 2013 to June 2014, the key policy rate was lowered from 11.75% to 8.50%, while the effective rate on one-week repo operations of the National Bank of Serbia has been revolving around 6.5%. Bearing in mind that the disinflationary effect of some factors is temporary (notably low cost-push pressure on food prices) and that geopolitical tensions have a strong impact on the country risk premium and the exchange rate, the National Bank of Serbia must be cautious in the conduct of monetary policy and its efforts to stabilise inflation at low levels in the longer run, while maintaining financial stability at the same time.

In the best collective judgement of the National Bank of Serbia's Executive Board, inflation will return within the target tolerance band until the end of 2014 and will stay therein in the course of 2015. Inflation's return within the target tolerance band will be supported by the waning of the disinflationary pressures from food prices, the anticipated adjustment of electricity prices and the rise in import prices.

As so far, in pursuing monetary policy objectives, the National Bank of Serbia will act responsibly and will seek to contribute to the creation of a stable and predictable business and investment environment.

Yours sincerely,

Dr Jorgovanka Tabaković

Submitted to:

– Mr Rasim Ljajić, Deputy Prime Minister and Minister of Trade, Tourism and Telecommunications
– Mr Dušan Vujović, Minister of Finance
– Ms Snežana Bogosavljević-Bošković, Minister of Agriculture and Environmental Protection

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Charts

Tables

Charts in boxes

Tables in boxes

Executive Board meetings and changes in the key policy rate

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
17 December	9.50	-50

2014

Date	Key policy rate (p.a, in %)	Change (in basis points)
16 January	9.50	0
13 February	9.50	0
6 March	9.50	0
17 April	9.50	0
8 May	9.00	-50
12 June	8.50	-50
10 July	8.50	0
7 August	8.50	0
11 September	8.50	0
16 October	8.50	0
13 November	8.00	-50
11 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 11 September 2014

At its meeting today, the NBS Executive Board decided to keep the key policy rate at 8.5%.

In keeping the rate unchanged, the Executive Board was guided primarily by the still present uncertainties in the domestic and international environment. Geopolitical tensions and the Fed's reduced monetary accommodation can exert a significant impact on movements in the international money and capital markets, affecting in particular the emerging market economies. The current geopolitical tensions also dampen optimism in terms of the pace of recovery of the euro area and Serbia's other important foreign trade partners. Lower external demand would probably lead to weaker export results and to a somewhat higher foreign trade deficit than anticipated earlier.

The Executive Board expects that the adoption and implementation of the indispensable fiscal consolidation measures and structural reforms will have a positive effect on market expectations regarding the sustainability of our public finance, and thus on the country risk premium. This would help moderate the risks which at this point warrant a cautious monetary policy.

The Executive Board stated that year-on-year inflation is still below the lower bound of the target tolerance band (4±1.5%). Based on NBS projection, inflation will gradually return within the target tolerance band until the end of the year, supported primarily by the waning of the effects of the drop in prices of primary agricultural commodities and the anticipated revision of administered prices, notably electricity.

The next rate-setting meeting will take place on 16 October.

Press release from Executive Board meeting held on 16 October 2014

At its meeting today, the NBS Executive Board voted to keep the key policy rate at 8.5%.

The Executive Board assessed that risks stemming from the domestic and international environment call for further caution in the pursuance of monetary policy. The current geopolitical tensions, including the expected further monetary tightening by the Fed, may adversely affect capital inflows into countries of the region, including Serbia. Moderate growth in the country's risk premium and depreciation pressures, prevailing in almost all countries of the region over the past several months, are indicative of reduced appetite of foreign investors.

The Executive Board expects that the adoption and consistent implementation of fiscal consolidation measures and structural reforms will affect positively the foreign investors' perception of Serbia, which may strengthen resilience to the above external risks and positively affect the country's risk premium in the coming period.

Year-on-year inflation is gradually returning towards the target of 4±1.5%. It equalled 2.1% in September. According to the NBS projection, though the expected adjustment of electricity prices did not take place, inflation will return within the target tolerance band by the year-end, and will move within the band throughout 2015. Inflation's return within the target band will be aided by the low base and gradual waning of the disinflationary effect owing to low food production costs, as confirmed also by the positive contribution of food prices to year-on-year inflation in September. In contrast, low aggregate demand, underpinned by new fiscal consolidation measures, remains the main disinflationary factor in the medium run. This is borne out also by low core inflation, trending below the target band for the second month in a row.

The next rate-setting meeting will be held on 13 November 2014.

Press release from Executive Board meeting held on 13 November 2014

In its meeting today, the NBS Executive Board decided to trim the key policy rate by half a percentage point, to 8 percent.

In making this decision, the Executive Board was guided by the fact that y-o-y inflation has been moving below the lower bound of the target tolerance band since March and that it is likely to remain there in the coming period given that the majority of factors will maintain their disinflationary impact.

Such inflation movements can be put down to factors with a temporary effect, notably the unexpectedly low growth in administered prices and international and local prices of primary commodities. The disinflationary pressures generated by factors with a lasting effect, such as aggregate demand, will be amplified still further by the cut in pensions and public sector wages.

The Executive Board expects that the initiated implementation of fiscal consolidation measures and structural reforms will moderate the negative impact of external factors stemming from uncertainties over monetary policy moves of the world's major economies. The Executive Board judges that the expected conclusion of an arrangement with the IMF will provide an additional assurance of the credibility of Serbia's economic policy.

The Executive Board also adopted the November Inflation Report which gives an overview of current macroeconomic developments and monetary policy measures. The Report will be presented to the public on 19 November.

The next rate-setting meeting will take place on 11 December 2014.

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