National Bank of Serbia

November 2015

INFLATION REPORT

2015

November

INFLATION REPORT

NATIONAL BANK OF SERBIA
Belgrade, Kralja Petra 12,
Tel: +381 11 3027-100

Belgrade, Nemanjina 17,
Tel: +381 11 333-8000

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

Introductory note

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

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

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

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

The November *Inflation Report* was considered and adopted by the NBS Executive Board in its meeting of 12 November 2015.

Earlier issues of the Inflation 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
EU – European Union
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
LHS – left hand scale
mln – million
NAVA – non-agricultural value added
NBS – National Bank of Serbia
NPLs – non-performing loans
OFO – other financial organisation
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
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Contents

I. Overview

Inflationary pressures remained subdued in the third quarter, under the impact of the majority of domestic factors, generally low inflation abroad and low prices of primary commodities in the international market.

Inflationary pressures remained subdued in the third quarter, under the impact of the majority of domestic factors, generally low inflation abroad and low prices of primary commodities in the international market. Consistent with expectations presented in the August *Inflation Report*, year-on-year inflation continued to move below the lower bound of the target tolerance band. Although the contribution of food prices remained positive, it was moderated in the third quarter by lower unprocessed food prices. Year-on-year inflation was also weighed down by prices of petroleum products as the decline in global oil prices continued. By contrast, administered prices provided a positive contribution from August onwards following the rise in electricity prices.

Though the recovery of the euro area is supported by the accommodative monetary policy stance of the European Central Bank, the weakening of the euro and lower oil prices, there are significant risks to the region's economic growth and inflation arising from the slowing growth of emerging markets, notably China.

The weakening of the euro, low oil prices and accommodative monetary policies continued to support economic activity in the euro area, which in turn positively affected growth in most Central and East European countries. Growth in the United States of America accelerated significantly in the second quarter, owing primarily to private consumption boosted by labour market recovery and higher real disposable income. On the other hand, China's economic slowdown stemming from gradual transition to a new growth model swayed monetary policy decisions of leading central banks. The Federal Reserve decided to keep its policy rate unchanged for the time being, while the European Central Bank hinted at the possibility of more monetary stimulus in December in order to spark economic activity and help inflation return to the target.

Uncertainties mounted in the global financial market during the third quarter,…

Signals of China's economic slowdown and the sudden devaluation of the Chinese national currency raised uncertainties in the international financial market in August, causing financial asset prices to tumble in stock exchanges worldwide. The market stabilised relatively quickly though, as the Chinese central bank eased its monetary policy stance and the Federal Reserve postponed its rate hike.

…temporarily driving up risk premia of emerging economies.

Risk premia of most emerging economies, including Serbia, rose during the third quarter, driven by mounting uncertainties in the international financial market, but fell sharply in October as the situation calmed. At end-October, Serbia's risk premium was 39 basis points lower than in June.

Due to the positive effect of domestic factors, Serbia's risk premium fell more sharply in October relative to June than the risk premia across the region.

The decline in Serbia's risk premium was sharper than in other emerging economies due to a substantial narrowing of internal and external imbalances, improved macroeconomic prospects and successful implementation of the arrangement with the International Monetary Fund. This, together with a higher inflow of foreign direct investment, led to appreciation pressures on the dinar. The supply of foreign exchange was increased also on account of the relatively high inflow of remittances and a further rise in foreign exchange-indexed bank assets. To prevent excessive short-term strengthening of the dinar, the National Bank of Serbia intervened in the interbank foreign exchange market to buy a total of EUR 520.0 million in the July-October period. The National Bank of Serbia intervened on the sale side on two occasions (August and October), each time selling EUR 10.0 mln.

Continued monetary policy easing reflected on money market rates and the cost of government and private sector borrowing...

Subdued inflationary pressures caused by low primary commodity prices in the international market, low inflation abroad, progress in fiscal consolidation at home, favourable external financial conditions and stabilised inflation expectations created room for substantial monetary easing in Serbia this year. In the current cycle of monetary easing begun in May 2013, the key policy rate was cut by a total of 7.25 percentage points. Continued monetary policy easing also reflected on money market rates and the cost of government and private sector borrowing.

… which encouraged lending.

Trends in the lending market improved in the third quarter, owing to past monetary easing, low rates in the international money market, the consequent fall in lending rates and improved growth prospects. Household lending continued rising at a pace similar to that in the prior year, and corporate lending growth, begun in June, continued over the coming months. Loans for current assets were approved at a similar dynamics as in the prior year when the subsidised lending scheme was in place, while strong growth in investment loans to corporates signals that private investment growth recorded this year was also financed from bank lending.

Fiscal consolidation measures have strongly contributed to sustainability of Serbia's public finances and greater resilience to external shocks.

Favourable fiscal movements continued into the third quarter, mostly owing to improved tax collection and lower expenditure. Consolidated budget deficit amounted to 1.8% of the estimated gross domestic product in the first three quarters, and was significantly below the ceiling envisaged by the agreement with the International Monetary Fund (5.3% in the first three quarters). At the same time, primary surplus of 1.9% of gross domestic product was recorded. Though fourth-quarter deficit is expected to be higher than in the third quarter, according to our estimates, the share of consolidated budget deficit in gross domestic product in 2015 will be around 4.0%, or some 2.5 percentage points lower than in the previous year. This is a very significant economic policy result, as it contributes to sustainability of Serbia's public finances and greater resilience to external shocks.

In the first nine months of the year, Serbia's current account deficit shrank by almost a quarter relative to the same period a year earlier and was fully covered by the net inflow of foreign direct investments.

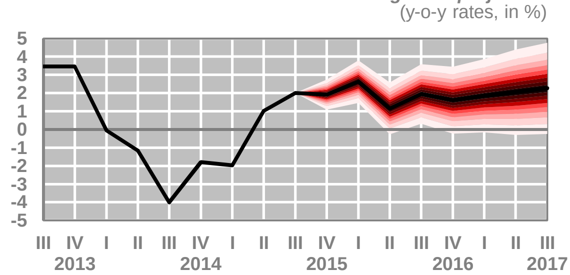
External imbalances declined further owing to the narrowing of internal imbalances, implementation of structural reforms and favourable external financial conditions. Current account deficit contracted from a year earlier and was fully covered by net inflow of foreign direct investment, reinforcing Serbia's external position. According to our projection, the narrowing of external imbalances will continue in the years to come.

Strong year-on-year growth in the gross domestic product continued into the third quarter.

Due to the full recovery of production in mining and energy sectors and continued positive trends in construction, the third quarter posted further year-on-year growth in gross domestic product, which according to the flash estimates of the Serbian Statistical Office equalled 2.0%. Following strong growth in the previous three quarters, industrial production subsided in the third quarter as anticipated, which was a major factor behind a mild seasonally adjusted fall in the gross domestic product of 0.4%. On the expenditure side, the strongest positive contribution came from private investment sustained by a better financial position of corporates and reforms taken in the course of the past two years in order to improve the business and investment environment, as reflected in Serbia's improved international competitiveness ranking. Higher private investment, however, pushed up imports of equipment.

Economic growth projection for this and the next year has been revised upwards to 0.8% and 1.8%, respectively.

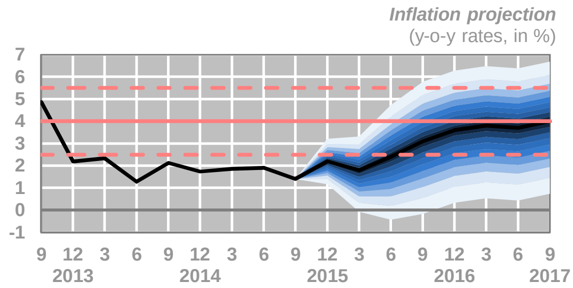
GDP growth projection
(y-o-y rates, in %)



Gross domestic product is expected to grow by 0.8% in 2015 and to step up to 1.8% in 2016. The above growth rates have been revised up by 0.3 percentage points relative to the August projection due to faster than expected growth in investment. Like in August, we expect that consistent fiscal adjustment and implementation of structural reforms will lead to higher investment. At the same time, negative contribution in 2015 will originate from household and government consumption that will be weighed down by the effects of fiscal consolidation. However, the drop in oil prices has increased disposable household income which, together with a higher inflow of remittances and low and stable inflation, has made the real fall in household consumption softer than anticipated. Economic activity growth in 2016 should be led by investment and exports, and after four years, positive contribution is also expected from household consumption.

Year-on-year inflation will be hovering around the lower bound of the target tolerance band until mid-2016 and is expected to trend steadily closer to the 4.0% target in the second half of the year.

Under our central projection, y-o-y inflation will be hovering around the lower bound of the target tolerance band until mid-2016. In H2 2016 it is expected to trend steadily closer to the 4.0% target. Inflation is expected to



return temporarily within the target tolerance band in January and stabilise more durably within the target band from mid-2016 onward. While on the short run the rise in inflation will be due to low last year's base for petroleum product and cigarette prices, in the medium term it will reflect the weakening of disinflationary pressures amid a gradual rise in aggregate demand and inflation in the international environment. The risks to the inflation projection are judged to be mildly tilted to the downside and are associated with economic developments abroad, international primary commodity prices and adjustment of administered prices next year. It is precisely due to these factors – lower prices of oil and primary agricultural commodities in the past year and much lower increase in administered prices relative to several years' trend – that inflation deviated from the central projection rate from the November 2014 *Inflation Report*, though it remained within the range projected at the time.

Monetary policy stance in the period ahead will depend primarily on international developments.

As inflationary pressures are likely to stay low in the period ahead, the monetary policy stance of the National Bank of Serbia should remain expansionary. Given the prevalence of external risks currently associated with movements in the international financial and commodity markets, the degree of monetary expansion will depend primarily on the assessment of their potential inflationary effect.

II. Monetary policy since the August *Report*

Monetary policy easing continued, with the key policy rate cut to 5.5% in August and further trimmed in each of the next two months by 50 bp to 4.5%. In November, the key policy rate was kept unchanged. In all, the current round of monetary easing begun in May 2013 saw the key policy rate cut by a total of 7.25 pp.

Additionally, in September the Executive Board decided to lower the FX reserve requirement ratio by 1 pp in each of the next six months. Together with key policy rate cuts, this is expected to lead to a further lowering of bank rates and contribute to a recovery in lending.

Strong monetary easing was underpinned by muted inflationary pressures generated by low world prices of primary commodities, low inflation abroad, progress in fiscal consolidation, favourable external financial conditions and stabilised inflation expectations.

Y-o-y inflation continued to move below the lower bound of the target tolerance band in the period following the August Report. Under the projection released at the time, y-o-y inflation was expected to gradually near the 4.0% target in H2 2016 and stay within the target tolerance band until the end of the projection horizon. It was estimated that administered prices would be the strongest inflationary factor in the period ahead (August increase in electricity prices and low last year's base for cigarette prices). By contrast, disinflationary effect was expected from global prices of primary commodities (oil and primary agricultural commodities), inflation abroad and tighter fiscal policy at home. The inflation projection for the year ahead was lower than the one released in May as the effect of prices of primary commodities was more disinflationary than expected. On the other hand, GDP projection for 2015 was revised upwards (growth of 0.5% instead of stagnation, mostly due to lower than expected drop in consumption), while the projection of 2016 growth remained unchanged (1.5%).

Starting from the August projections of inflation and economic activity and incoming information on economic developments, the NBS Executive Board cut the key policy rate by 50 bp in each of its three meetings from August through October, down to 4.5%. The decision on continued monetary easing was driven by expectations of low inflationary pressures in the period ahead, as well as by the need to bring inflation back to target and support economic recovery. That inflationary pressures were low was also signalled by the fact that inflation expectations were anchored within the NBS's target tolerance band, with expectations of the financial and corporate sectors falling below 4%.

Despite substantial monetary easing in the prior period (200 bp in March-June 2015), progress in fiscal consolidation and continuing favourable external financial conditions created room for further lowering of the key policy rate. Data on public revenue and expenditure indicated that the fiscal deficit would fall well short of the initially planned 5.9% of GDP mark. The government has borrowed at declining rates since the start of the year, owing to macroeconomic stability (including primarily low inflation and a relatively stable exchange rate), cuts in the NBS key policy rate and extremely low global financial market rates.

Reduced internal imbalances and structural reforms, along with favourable external financial conditions, contributed to a further narrowing of external imbalances and relative stability of the exchange rate. Current account deficit contracted and was fully covered by net FDI. As capital inflows were higher than the current account deficit, foreign exchange reserves increased, strengthening Serbia's external position and bolstering its resilience to possible extrenal shocks. An improved macroeconomic outlook of the country was also supported by the second positive review of the IMF arrangement.

When deciding on the key policy rate, the Executive Board also took account of the global slowdown in economic growth, which was likely to result in longer than expected pursuit of accommodative monetary policies by advanced economies. This would have a positive impact on liquidity in the international financial market, mitigating risks regarding capital flows to emerging economies.

Guided by the need to encourage aggregate demand and economic recovery through the credit channel, the Executive Board decided in its September meeting to cut the FX reserve requirement ratio by 1 pp in each of the coming six months. Hence, as of February 2016, FX reserve requirement ratios on sources maturing in up to two years will be 20%, and ratios on sources of longer maturities 13%. As dinar reserve requirement ratios have remained unchanged (5% on sources maturing in up to two years and 0% on sources of longer maturities), banks continue to be encouraged to use dinar sources of funding.

In view of the expected effects of past key policy rate cuts and gradual trimming of the FX reserve requirement ratio on inflation movements in the period ahead, in an environment of persistent external risks, in November the Executive Board decided to keep the key policy rate unchanged.

Past monetary policy measures and gradual waning of disinflationary effects of the fall in prices of primary agricultural commodities are expected to bring y-o-y inflation closer to the 4% target from mid-2016 onwards. Monetary policy measures – key policy rate cuts and gradual trimming of the reserve requirement ratio – are expected to contribute to further lowering of lending rates and lead to a recovery in lending activity and higher aggregate demand.

III. Inflation movements

Consistent with expectations presented in the August Inflation Report, y-o-y inflation continued below the lower bound of the target tolerance band in Q3. Though positive, the contribution of food prices to y-o-y inflation was smaller, reflecting a decline in unprocessed food prices. A drag also came from petroleum product prices which mirrored a further drop in global oil prices. In contrast, owing to the electricity price hike, as of August the contribution of administered prices became positive again.

In addition to the majority of domestic factors, subdued inflationary pressures in Q3 were still driven by low primary commodity prices in the global market and low inflation in the international environment. Prices declined marginally at the quarterly level, on account of falling unprocessed food prices (broken down by component).

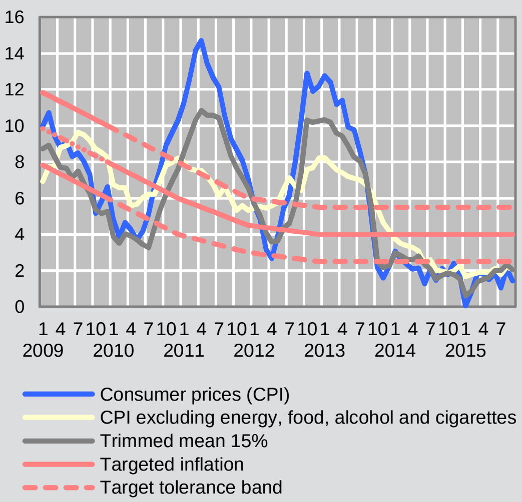
A protracted period of low inflation and expected subdued inflationary pressures brought about a further decline in inflation expectations. Financial and corporate sectors expect inflation below the NBS target midpoint of 4% in October 2016 and 2017.

Inflation movements in Q3

Inflationary pressures remained subdued in Q3 reflecting the majority of domestic factors, low primary commodity prices in the global market and low inflation in the international environment.

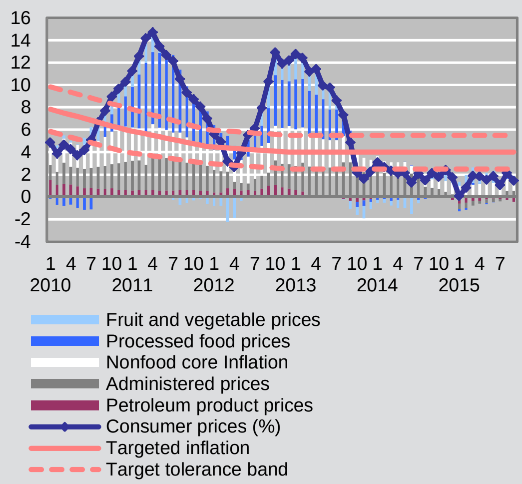
Consistent with expectations presented in the August *Inflation Report*, y-o-y inflation continued below the lower bound of the target band in Q3. It measured 1.4% in September. The contribution of food prices to y-o-y inflation was positive (0.3 pp in September), but smaller than in Q2 (1.1 pp) because of a drop in unprocessed food

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



Sources: SORS and NBS calculation.

Chart III.0.2 **Contribution to y-o-y consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

prices. A drag on y-o-y inflation also came from petroleum product prices (-0.4 pp in September vs. 0.2 pp in June) which mirrored a further drop in global oil prices in Q3. Conversely, the August electricity price hike of 12.2% (contribution: 0.6 pp) had a one-off upward effect on inflation. As a result, administered prices, on a downward path since early 2015, began to record y-o-y growth as of August.

In quarterly terms, Q3 saw a marginal drop in consumer prices (0.1%). As forecast in the August *Report*, the major positive contribution originated from administered prices, i.e. electricity and cigarettes (0.7 pp). A negligible deviation from the assumption of a moderate quarterly rise in consumer prices, presented in the August *Report*, was due primarily to a sharper than expected drop in fruit and vegetable prices. Despite high temperatures and the drought, these prices recorded a much smaller rise in August and September than in previous drought years, which did not suffice to offset their sharp fall in July (almost 15%).

Unlike Q2 when it was neutral, the contribution of **prices of food and non-alcoholic beverages** turned negative in Q3 (-0.6 pp), under the influence of unprocessed food prices. The price reduction in the **unprocessed food** category (6.3%, contribution: -0.8 pp) was led dominantly by vegetable prices (-18.8%, contribution: -1.0 pp), while an increase in fresh meat prices worked in the opposite direction, though to a much lesser extent. At the same time, **processed food** prices rose moderately (0.9%, contribution: 0.2 pp), reflecting a rise in vegetable oil and sugar prices.

Following the Q2 growth, led by the recovery of global oil prices in early Q2, **petroleum product prices** in the domestic market declined in Q3 (3.9%, contribution to inflation: -0.2 pp). This was due to a renewed drop in global oil prices and moderate strengthening of the dinar against the dollar in that quarter. In September, petroleum product prices were by around 9% lower than a year ago. Q3 also saw lower prices of household gas (11.1%). However, as electricity prices were raised, prices within the **energy** group gained 2.2% (contribution: 0.3 pp).

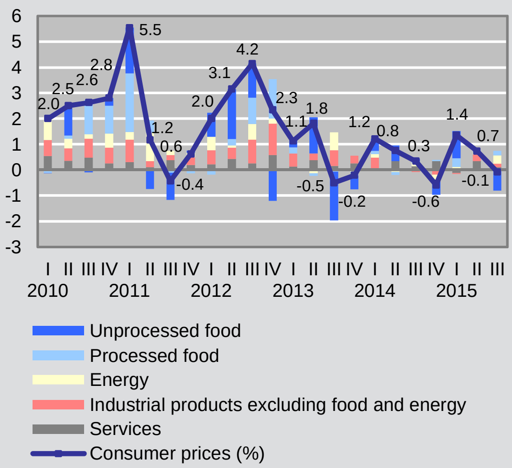
Industrial product prices excluding food and energy picked up by 0.5% in Q3 (contribution: 0.1 pp), on the back of the July cigarette price increase (3.5%). Cigarette prices went up as a result of the minimum excise adjustment and the producers' business policy. On the other hand, relative stability of the dinar since early 2015 and muted domestic demand limited price growth in other product categories in the group, which is why their contribution was neutral.

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

	Share in CPI	2014	2015		
		IV	I	II	III
Consumer prices (CPI)	100.0	-0.6	14	0.7	-0.1
Unprocessed food	12.0	-4.0	8.6	-0.2	-6.3
Processed food	20.8	0.2	17	0.3	0.9
Industrial products excluding food and energy	28.5	-0.6	-0.1	0.9	0.5
Energy	15.4	-18	0.7	0.7	2.2
Services	23.3	16	-0.5	15	0.4
Core inflation indicators					
CPI excluding energy	84.6	-0.4	15	0.7	-0.5
CPI excluding energy and unprocessed food	72.7	0.3	0.3	0.9	0.6
CPI excluding energy, food, alcohol and cigarettes	44.5	13	-0.5	10	0.2
Administered prices	19.8	-14	-0.1	0.8	3.7

Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

Services prices were also slightly up in Q3 (0.4%, contribution: 0.1 pp). Within this group, utility and education prices rose mildly, while prices of travel packages declined a tad, following the Q2 hike prompted by the onset of the tourist summer season. Prices of other services edged up marginally, notably due to the persistently muted domestic demand and a stable dinar.

Core inflation (measured by CPI excluding prices of energy, food, alcohol and cigarettes) arrived at 0.2% in Q3. A positive impulse came from prices of utilities, education and medicaments. The seasonal drop in prices of clothes and footwear, and a reduction in prices of telephones and computers provided a negative contribution. Y-o-y, core inflation continued below the lower bound of the target tolerance band. It measured 2.1% in September.

Administered price growth in Q3 (3.7%, contribution: 0.7 pp) outstripped that in Q2, reflecting mainly a rise in electricity and cigarette prices, whilst a reduction in gas prices worked in the opposite direction. From early 2015, administered prices grew 4.4%.

Producer and external prices

The new drop in global oil prices in Q3 weighed down strongly on **industrial producer prices in the domestic market** (down by 1.7%), predominantly on account of prices of petroleum product producers (1.8 pp – down by 32.3%). In addition, the chemical industry also witnessed a relatively vigorous fall in producer prices (9.2%), largely reflecting lower prices of natural gas. On the other hand, the strongest producer price growth was observed in the production of tobacco and food products. In terms of purpose, producer prices of energy and intermediate goods declined in Q3, whilst producer prices of non-durable consumer goods went up. Producer prices declined also in y-o-y terms, by 1.2% in September.

Growth in **agricultural producer prices**[1] continued in Q3 (6.4%). Such trends were led by rising prices of live cattle and industrial plants, whereas the prices of cereals, fruits and vegetables were on a decline. Y-o-y, after twelve consecutive months, agricultural producer prices increased in September (5.8%).

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

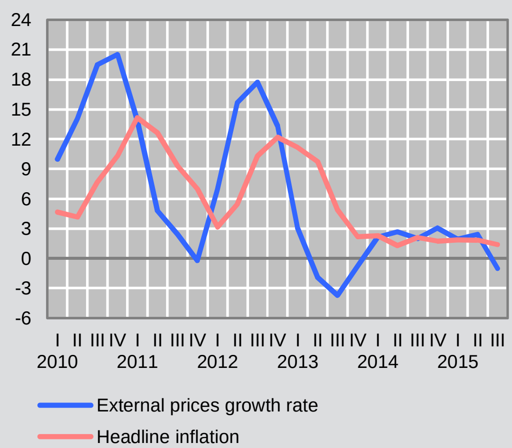
	2014	2015		
	Dec.	March	June	Sept.
Consumer prices	17	19	19	14
Domestic industrial producer prices	0.2	0.7	12	-12
Agricultural producer prices	-7,9	-3.0	-5.8	5.8
Prices of elements and materials incorporated in construction	4.6	0.7	10	-17

Sources: SORS and NBS calculation.

On a constant monthly fall in Q3, **prices of elements and materials incorporated in construction** were down by 1.6% in quarterly terms. After more than three years, these prices fell at y-o-y level as well, measuring 1.7% in September.

A decline in global oil prices had the strongest impact on a reduction in **external dinar-denominated prices** of 2.8% in Q3. Besides oil, a contribution to lower external

Chart III.0.4 **Domestic inflation and external prices**
(y-o-y rates, in %)



Sources: Destatis, FAO, Bloomberg and NBS calculation.

[1] Producer prices in agricultural and fishing sectors.

prices also came from a further decline in world food prices, where all groups apart from meat witnessed a fall. Furthermore, a decline was observed for German export prices and EU consumer prices, which are used to approximate external prices of intermediate goods and services. The nominal appreciation of the dinar against the euro (0.3%) and the dollar (0.5%) in Q3 resulted in lower dinar-denominated external prices. After a year and a half, external prices saw a y-o-y decline in Q3 – by 1.1% in September.

Inflation expectations

Medium-term inflation expectations continued within the target tolerance band. Standing below the mid-point, one-year ahead inflation expectations of financial and corporate sectors have been the lowest on record.

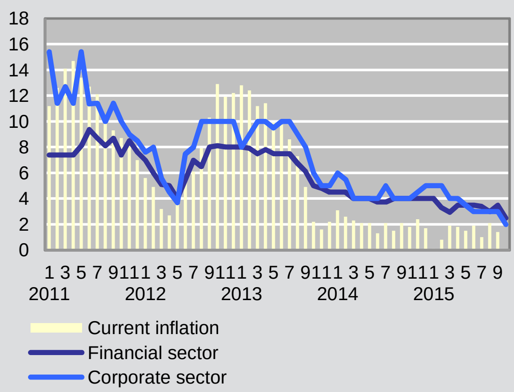
At the target level in August (for the seventh consecutive month), **one-year ahead** financial sector expectations were constantly pared down – according to the **Bloomberg** survey, they measured 3.2% in November. Financial sector expectations have been within the target band for more than two years. Judging by the **Ninamedia**[2] survey, following a drop to 3.0% in August, financial sector expectations returned to 3.5% in September (where they stood in Q2), only to fall to 2.5% in October.

Inflation expectations of the corporate sector were on a continuous decline in H1. They fell to 3.0% in June, where they stayed in September. In October, they fell below the lower bound of the target tolerance band (to 2.0%) for the first time.

One-year ahead expectations of households were at a one-time high in July and August (8.0% and 7.0% respectively), chiefly due to the electricity price increase. They dropped to 6.0% in September and 5.0% in October. In terms of qualitative household expectations, the percentage of those expecting a significant price increase was at a minimum in October and September (14%). Most respondents expect a moderate or slight price increase over the coming year (65%). Besides, 14% of them expect no price changes, 3% anticipate a fall, while 4% do not know.

Medium-term inflation expectations of all sectors have been within the target band for more than half a year. Two-year ahead financial sector expectations rose from the August low of 3.5% to 3.8% in September, only to fall

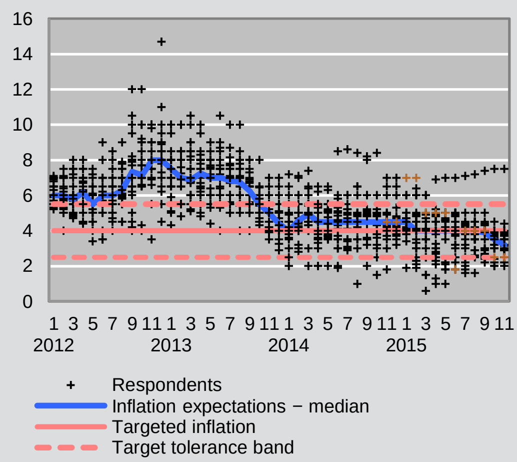
Chart III.0.5 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Gallup, Ipsos, Ninamedia and NBS.

* Ninamedia agency since December 2014, and Ipsos and Gallup in the prior period. The survey was not conducted in November 2014.

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



Sources: Bloomberg and NBS.

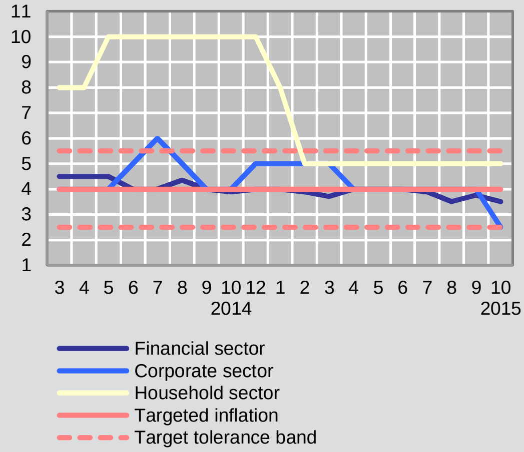
[2] Ninamedia clipping d.o.o. Novi Sad has been conducting a survey on expectations of economic entities since December 2014, in accordance with the methodology applied so far.

back to 3.5% in October. At the midpoint (4.0%) for half a year, corporate expectations edged down to 2.5% in October. For the ninth month in a row, households expect two-year ahead inflation at 5.0%.

The dispersion of financial sector responses, which is the lowest among all sectors, remained relatively stable both according to Bloomberg and Ninamedia surveys. The dispersion of corporate sector responses narrowed further in the absence of any major inflationary pressures. The dispersion of household sector responses recorded a longer period of relative stability.

Q3 saw a reduction in the net percentage[3] of enterprises expecting a rise in their product prices to only 3.4%. The net percentage of enterprises expecting a rise in their input prices also declined – to 13.2%. These percentages have been on a decline for more than a year. Based on our estimate, this reflects subdued inflationary pressures and muted domestic demand, which limits the pass-on of any major production costs to consumers.

Chart III.0.7 **Two-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Ipsos/Ninamedia.
* The survey was not conducted in November 2014.

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

IV. Inflation determinants

1. Financial market trends

Continued monetary policy easing reflected on money market rates and the cost of government and private sector borrowing, which fell to their all-time lows. Macroeconomic performances have improved, as also confirmed by completion of the second review of the arrangement with the IMF. Coupled with more robust FDI inflows, this sustained the stability of the exchange rate in Q3, though appreciation pressures prevailed. FX supply increased also on account of the relatively high inflow of remittances and a further rise in FX-indexed bank assets.

Interest rates

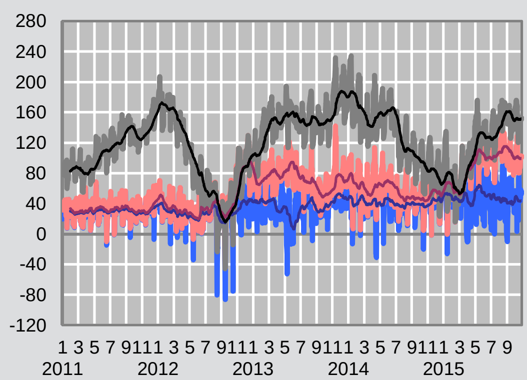
The key policy rate cut fully reflected on a decline in the average repo rate[4], which fell by 1.0 pp in Q3 to 3.0% in late September. Throughout the period under review, the repo rate was almost equal to the deposit facilities rate.

Trading volumes in the interbank overnight money market contracted further in Q3. Average daily trading volumes amounted to RSD 1.5 bln, down by RSD 0.6 bln from Q2. In July and August, BEONIA displayed stronger volatility as the market responded to the escalation of the Greek crisis. Uncertainties eased in late August after the agreement was reached with creditors, and BEONIA came closer again to the deposit facilities rate. It averaged 3.5% in September, down by 0.9 pp compared to its average June value.

Unlike the overnight money market rate, BELIBOR rates mirrored the movement in the average repo rate throughout Q3. In September, they averaged between 3.8% for the shortest and 5.0% for six-month maturity, down between 1.0 pp and 1.3 pp relative to June. The yield curve slope moderated further in Q3, also on the back of lower inflation expectations.

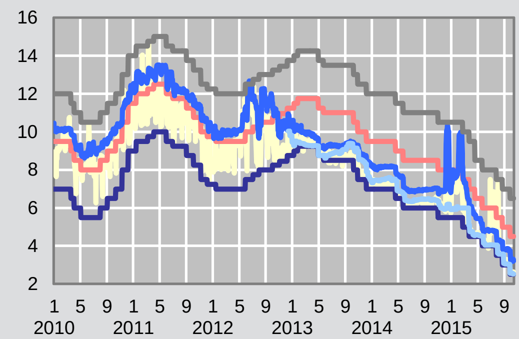
In October, interbank money market rates declined further, while trading volumes in the overnight money market increased.

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



Source: NBS.

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



Sources: Thomson Reuters and NBS.

[4] Rate recorded at repo auctions weighted by the amount of sold securities.

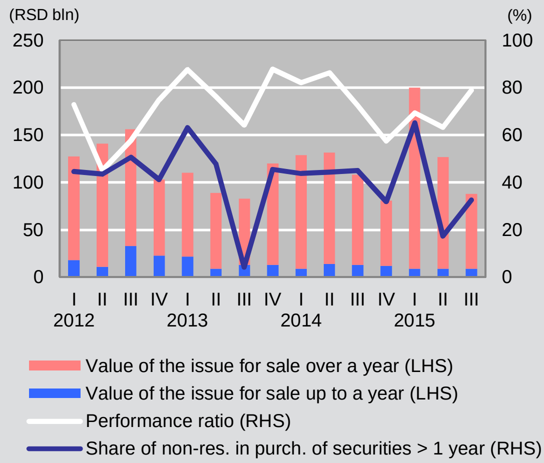
Monetary accommodation and improved fiscal position brought about a further decline in rates at auctions of dinar government securities. In late Q3, rates on these securities ranged between 4.4% for three-month and 6.8% for two-year securities, down by 1.2 pp and 0.4 pp from Q2. At the auction of two-year amortising bonds at a variable coupon linked to the key policy rate, the fixed margin narrowed by 0.3 pp to 0.9%. Positive effects of fiscal consolidation diminished the risk of investment in government securities and reduced the government's borrowing needs. Thus, the amount of securities offered for sale declined further relative to Q2. The longest term of government borrowing in Q3 was three years – at a 6.6% rate in September. That was the only Q3 auction involving non-residents.

Interest rates continued down in October. The rate at the auction of five-year securities (6.5%) was lower than the rate recorded at the September auction of three-year securities.

At auctions of government euro securities, a decline was noted for rates on two-year (by 0.7 pp to 2.2%) and ten-year securities (to 4.5% – down by 1.0 pp relative to the last auction of November 2014). Rates on one- and three-year securities remained broadly flat at 1.6% and 3.9% respectively. The share of non-residents in the primary purchase of these securities was modest.

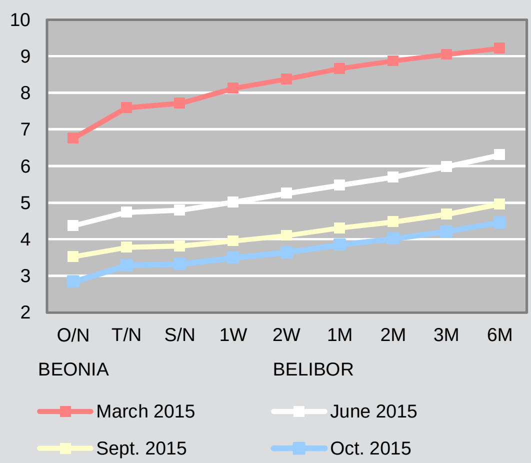
Rates in the secondary market of government securities also declined, while trading volumes increased. Total trading volumes in the market amounted to RSD 65.5 bln, up by RSD 13.8 bln from Q3. Most traded were three- and seven-year bonds. Rates of return mirrored movements in the primary market, ranging in September from 3.5% for

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



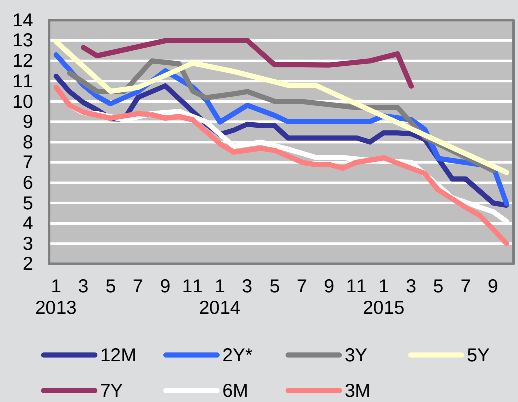
Source: Ministry of Finance.

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



Sources: Thomson Reuters and NBS.

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



Source: Ministry of Finance.

* Excluding coupon securities with the rate linked to the NBS key policy rate.

the remaining one-month to 8.1% for the remaining 76-month maturity.

Further monetary policy easing brought about a further decline in lending rates – in Q3, they fell to their lowest level on record[5].

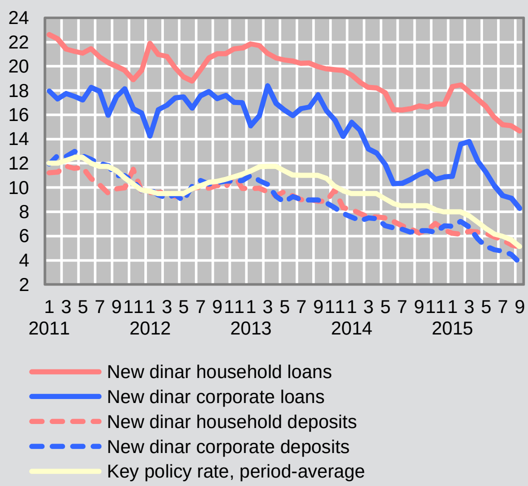
The weighted average rate on dinar corporate and household loans fell by 1.8 pp to 11.7% in September. Rates on corporate loans are now one-digit – they fell by 1.9 pp to 8.3%. Rates on all types of dinar corporate loans declined, most notably on investment loans (by 3.0 pp to 7.5%). Rates on current assets loans fell to 8.3% (by 2.5 pp), while the rate on other loans fell somewhat less, equalling 8.7% in September. Rates on household loans fell by 1.1 pp to 14.7% in Q3. In September, apartment renovation loans were extended at an average rate of 10.1%, consumer loans at 11.5%, and cash loans at 15.2%. It was only the price of other loans that picked up negligibly – to 13.1%.

The cost of FX and FX-indexed lending also declined, though to a lesser extent than the cost of dinar lending. The weighted average rate on new euro and dinar euro-indexed loans fell by 0.2 pp to 4.7% in September. Average rates on corporate and household loans fell by the same amount – in September, they equalled 4.5% and 6.0% respectively. In regard to corporate loans – as it was the case with dinar loans, the sharpest decline was noted for investment loans (by 0.6 pp to 4.8%). Rates on current assets loans fell to 4.5%, and rates on other loans to 3.8%. In September, rates on FX and FX-indexed household loans moved between 4.2% for housing and 8.4% for other loans. At the same time, the cost of housing, cash and consumer loans went up slightly, while rates on other loans declined.

Judging by the bank lending survey, lower cost of funding and greater competition among banks were the main factors behind the easing of lending terms. The decline was steeper for rates on new dinar deposits, which fell by 1.1 pp to 3.9% in September. Rates on dinar corporate deposits fell by the same amount – they equalled 3.8% in September, while rates on household savings were down by 0.9 pp to 5.1%. Rates on new euro corporate and household deposits fell by 0.1 pp each, to 0.7% and 1.0% respectively. As a result, the weighted average rate on new euro deposits reached 0.8% in September.

In the course of Q3, lending rates declined more than deposit rates, triggering a fall in both dinar and euro interest margins. As the difference in the decline in dinar rates was somewhat more pronounced, the fall in the dinar interest margin was sharper.

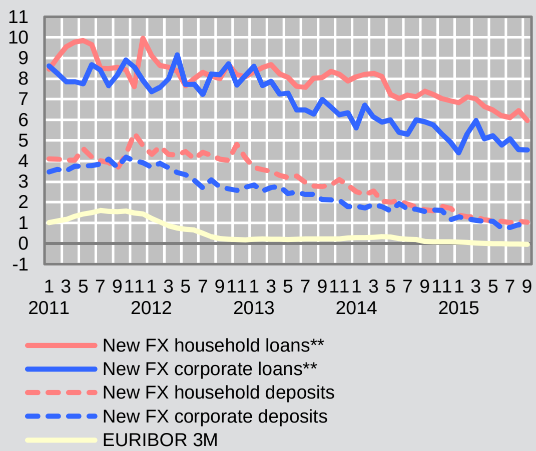
Chart IV.1.6 **Interest rates on new dinar loans and deposits of corporates and households***
(weighted average values, p.a., in %)



Source: NBS.

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

Chart IV.1.7 **Interest rates on new FX loans and deposits of corporates and households***
(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.

[5] As of September 2010.

Risk premium

Measured by EMBI, Serbia's risk premium was relatively stable in the first half of Q3, but displayed volatility in the second half. It measured 310 bp in late Q3, up by 13 bp from late Q2. Risk premia of other countries in the region increased as well.

The rise in Serbia's risk premium may be largely ascribed to turbulences in the international financial market, while the impact of domestic factors was favourable. The main contribution came from significant narrowing in internal and external imbalances, improved macroeconomic prospects of the country, and successful implementation of the arrangement with the IMF. During September and October, Serbia's risk premium trended below those of Croatia and Turkey.

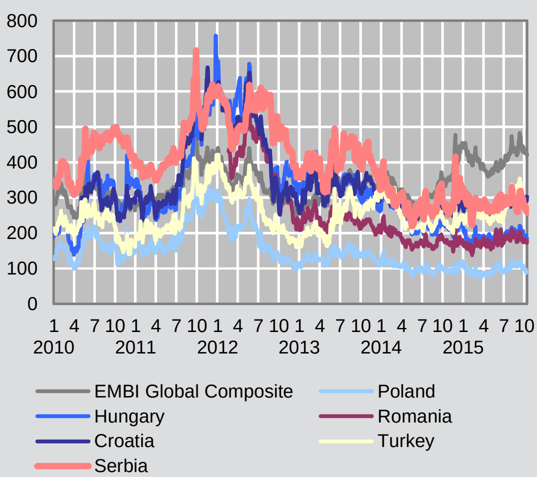
Still, global factors also exerted a significant influence on Serbia's risk premium, particularly as of mid-August when the difference in yields relative to the benchmark ten-year US treasury note (as in other emerging economies) varied significantly over uncertainties in the international financial market. The Chinese stock market rout and signals of possible slowdown in China's growth (and, by extension, global growth), uncertainties surrounding the start of the Fed's rate hike and the dollar exchange rate were the main factors considered by investors when assessing risks of these countries. In Q3, EMBI went up for Romania (7 bp), Poland (10 bp), Hungary (24 bp), Croatia (37 bp), and most notably for Turkey (91 bp). EMBI Global again outstripped 400 bp, up by 82 bp in Q3 (in September, it reached its highest level since October 2011 – 483 bp).

As the Chinese central bank eased its monetary policy and the Fed postponed its rate hike, risk premia of emerging economies experienced a fall in October. While expecting economic growth, analysts assess that the US dollar exchange rate may be the most important factor that investors take into account when assessing the risk of emerging economies as its appreciation may aggravate debt servicing in many of these countries. In October, risk premia of almost all emerging economies were on a decline. Serbia's EMBI fell by 52 bp to 258 bp, and EMBI Global also fell by 52 bp to 422 bp by end-October.

Foreign capital inflow

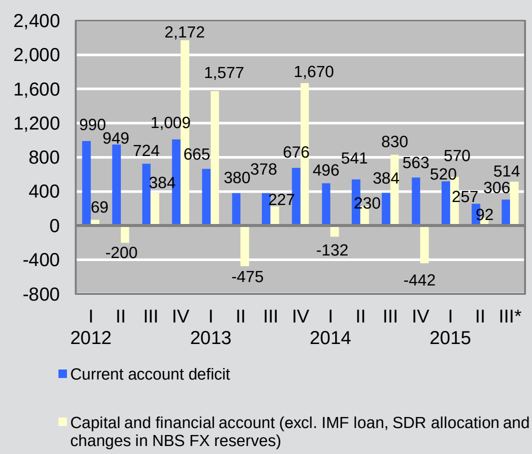
Since early 2015, net capital inflow from FDIs alone sufficed to cover the current account deficit. In addition, Q3 saw an increase in resident credit liabilities. At the same time, banks held lower balances in accounts

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



Source: JP Morgan.

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



Sources: SORS and NBS.
* Preliminary data.

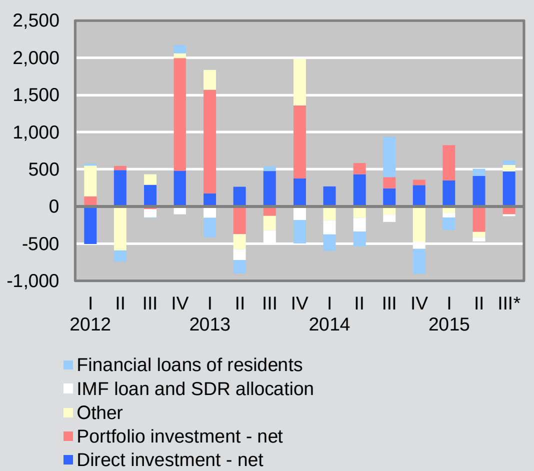
abroad, while an outflow was recorded for portfolio investment.

In Q3, FDIs accounted for the major portion of the financial account inflow. According to preliminary data, Q3 saw a net **FDI** inflow of EUR 470.3 mln. Of this, EUR 448.2 mln concerned equity and EUR 150.0 mln reinvested earnings. In contrast, net capital outflow (EUR 128.0 mln) was recorded in respect of debt instruments[6]. Net foreign payments in regard to dividends and interests amounted to EUR 121.2 mln and EUR 21.9 mln respectively.

In the first nine months of 2015 FDI inflow came at EUR 1.2 bln, up by 30% y-o-y. The FDI inflow is expected at around EUR 1.6 bln in 2015 and should fully cover the expected current account deficit. Over the past years, the share of FDIs in tradeable sectors has been on a rise, which will, in the medium run, bring about a further rise in exports and improved sustainability of the country's external position.

Q3 saw a capital outflow of EUR 105.2 mln in respect of **portfolio investment**, while interest payments to investors amounted to EUR 129.2 mln. Foreign investors have shown interest in longer-term securities for a longer time already. As the government held a three-year auction

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



Sources: SORS and NBS.
* Preliminary data.

for the first time after five months, non-residents were net buyers of government securities in September. However, the September inflow was lower than the amount of securities owned by non-residents which fell due in Q3. At the same time, residents stepped up investment in foreign securities, which resulted in an outflow on this account at the quarter-level.

Resident liabilities arising from **financial loans** went up by EUR 35.2 mln in Q3. Net government borrowing was up by EUR 71.3 mln. The servicing of liabilities due equalled EUR 187.2 mln, while the loans disbursed were worth EUR 258.5 mln – those were IBRD loans for the development and restructuring of enterprises, flood recovery and road repair, and EIB loans for Corridor X and regional and municipal infrastructure. Banks repaid EUR 3.6 mln in Q3 or EUR 184.8 mln since early 2015. The fact that debt repayment towards parents is slowing down is confirmed by an outflow that was three times lower than in the first nine months of 2014 (EUR 540.4 mln). The NBS repaid its foreign debt worth EUR 26.3 mln, with the bulk of payments going to the IMF in respect of the arrangement concluded in 2009. Since early 2015, EUR 130.2 mln was paid to the IMF. Enterprises repaid their foreign debt in respect of financial loans by EUR 6.2 mln in Q3 or EUR 47.1 mln since the start of 2015. Net outflow in respect of trade loans came at EUR 68.4 mln in Q3 or EUR 61.2 mln since the start of the year.

Trends in the FX market and exchange rate

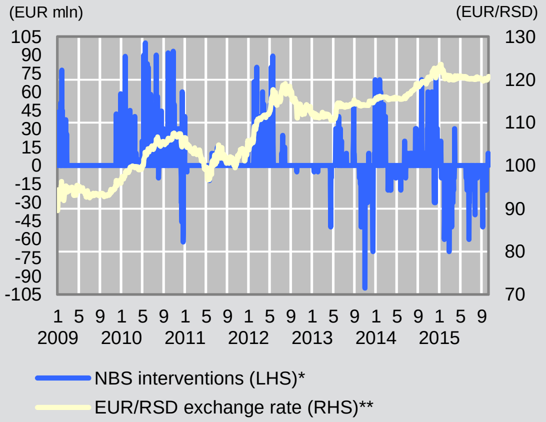
Though under somewhat stronger appreciation pressures, the dinar remained stable in Q3. The dinar gained 0.7% against the euro end-of-period, or 0.2% in average quarterly terms. It ranged between 119.7 and 120.6 for one euro.

As markets expected the Fed to postpone the rate hike, the euro strengthened 0.4% vis-à-vis the dollar. As a result, the dinar appreciated by 1.2% against the dollar in Q3 (end-of-period).

Improved macroeconomic performances and fiscal consolidation results, as also confirmed by the completion of the second review of the arrangement with the IMF, were reflected in movements in the dinar exchange rate in

[6] 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*.

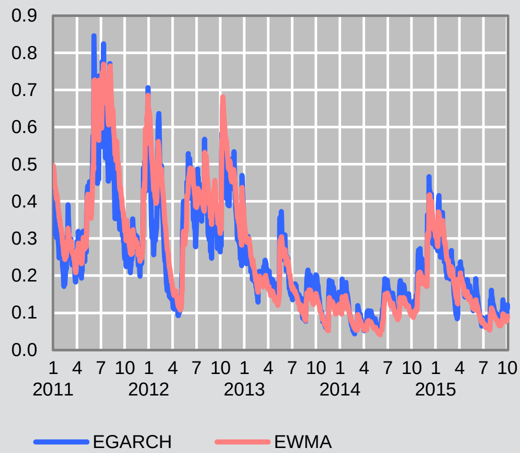
Chart IV.1.11 **Movements in EUR/RSD exchange rate and NBS FX interventions**



Source: NBS.

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

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



Source: NBS.

Q3. The FDI inflow increased, while in September, non-residents stepped up their investment in government securities – at the quarter-level, they were net FX buyers from banks to a much lesser extent than in Q2. The inflow of remittances was relatively high in Q3, reflecting on amounts of foreign cash purchases from exchange offices. Further growth in FX-indexed bank assets – partly due to the maturing of dinar loans and more intensive approval of FX-indexed loans – also led to the dinar's appreciation as banks increased FX supply in the IFEM in an effort to align their FX positions. On the other hand, FX sales to enterprises for import purposes were somewhat higher than seasonal.

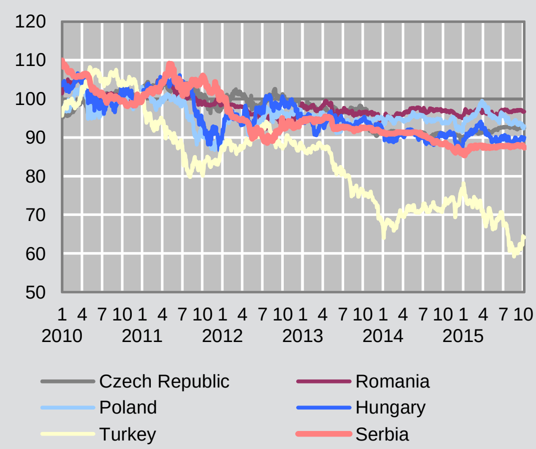
Trading in the IFEM declined further in Q3 and averaged EUR 22.9 mln, down by EUR 8.8 mln from Q2.[7] The highest value of turnover was recorded in August (EUR 29.2 mln) and the lowest in September (EUR 16.7 mln). Measured by EWMA[8] and EGARCH[9], volatility of the dinar against the euro was low in Q3.

The dinar remained broadly stable in October, though exposed to short-term depreciation pressures by the end of the month. As a result, it weakened by 0.8% at the month-level.

To prevent excessive short-term appreciation of the dinar, in Q3 the NBS intervened in the IFEM by purchasing EUR 450.0 mln. It intervened on the sale side only once – with EUR 10.0 mln in August. In the course of October, the NBS purchased EUR 70.0 mln and sold EUR 10.0 mln.

The volume of transactions at regular FX swap auctions organised by the NBS increased in Q3. Growth was

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.

[7] Excluding NBS.
[8] EWMA – Exponentially Weighted Moving Average.
[9] EGARCH – Exponential General Autoregressive Conditional Heteroskedasticity.

recorded at two-week auctions (EUR 161.0 mln both sold and bought). At three-month auctions, it bought EUR 20.0 mln and sold the same amount. The amount of interbank FX swaps increased significantly – to EUR 132.5 mln in Q3.

The majority of currencies of other countries in the region running similar exchange rate regimes were stable in Q3. End-of-period, the Romanian leu, Hungarian forint and Czech korona gained 1.3%, 0.5% and 0.2% respectively, while the Polish zloty lost 1.0%. It was only the Turkish lira that experienced stronger depreciation (12.8%).

Stock exchange trends

Following a moderate rise in July, indices of the Belgrade Stock Exchange (BSE) declined in August and September. Such trends were prompted by elevated risks in the global financial market and the fact that Serbia's oil company accounted for a significant share (19%) of BELEX15. As a result, BELEX15 and BELEXline fell in Q3 by 2.7% and 0.7% respectively. At end-September, BELEX15 (most liquid shares) equalled 628.3 points and BELEXline (general index of shares) 1,318.9 points.

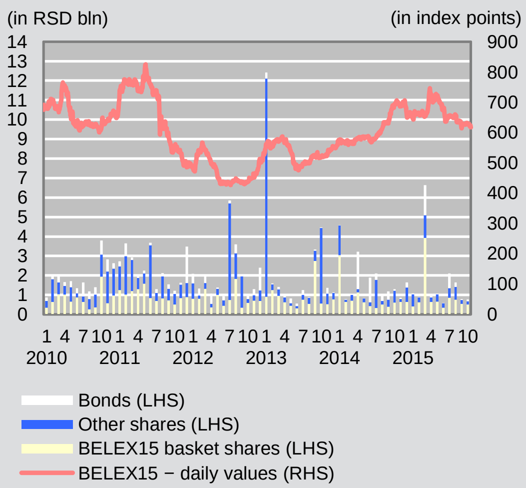
Total BSE trading in shares was up by RSD 1.3 bln to RSD 3.8 bln in Q3. Mirroring the movement in prices of shares, trading volumes increased in July and August (RSD 1.7 bln and RSD 1.4 bln respectively), but halved in September.

In Q3, foreign investors were more active on the BSE, participating in somewhat more than a half of total trading in shares, mostly on the sale side (RSD 0.7 bln net).

Trading in A2016-series bonds outstripped the Q2 figure and amounted to RSD 1.1 bln. The yields on these securities declined to 1.3% at end-Q3. An important step in the development of the local capital market is the possibility to trade in long-term government securities via the stock exchange, which began in November.

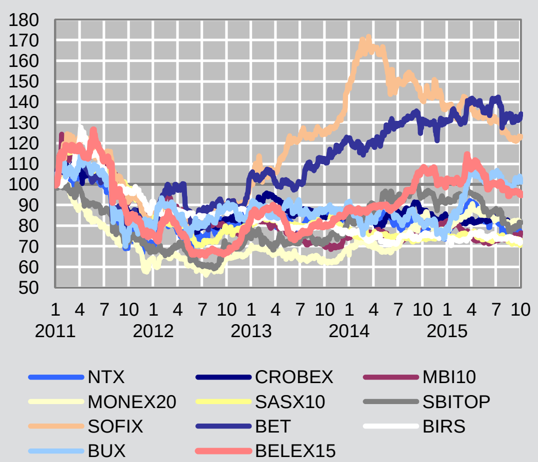
As prices of shares declined, the BSE market capitalisation contracted – down by RSD 5.7 bln from end-June to RSD 714.9 bln in late September. Of this, regulated market capitalisation fell by RSD 4.9 bln and MTP[10] capitalisation by RSD 0.8 bln. The share of market capitalisation in estimated GDP was down by 0.3 pp to 18.2% in late Q3.

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



Source: Belgrade Stock Exchange.

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



Sources: BSE and regional stock exchanges.

[10] 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.

Indices recorded a decline in most countries of the region (generally steeper than on the BSE). The drop was the most pronounced in Ljubljana (9.0%) and Sofia (8.8%). A rise was noted only for the Skopje index (3.9%).

2. Money and loans

Money supply, particularly its dinar component, increased in Q3. After a lengthy interval, an impulse to this increase came from lending to the private sector.

Monetary aggregates

In Q3, dinar reserve money lost 3.3% in nominal and 3.2% in real terms. Total reserve money declined more sharply (by 4.0% in nominal or 3.9% in real terms), as banks' FX deposits with the NBS shrank with the start of a new round of cuts in the FX reserve requirement ratio. Y-o-y, real growth in dinar reserve money slowed to 10.9% in September, and total reserve money lost 6.1% in real terms.

In Q3, dinar reserve money was withdrawn mostly through banks' increased investment in repo securities (RSD 40.0 bln) and higher government dinar deposits with the NBS (by RSD 31.9 bln). A smaller amount was also mopped up through government purchases of foreign currency from the NBS (RSD 4.4 bln). Conversely, the increase in reserve money resulted mostly from NBS's net FX purchases in the IFEM (RSD 44.5 bln) and FX payment transactions with Kosovo and Metohija (RSD 13.9 bln).

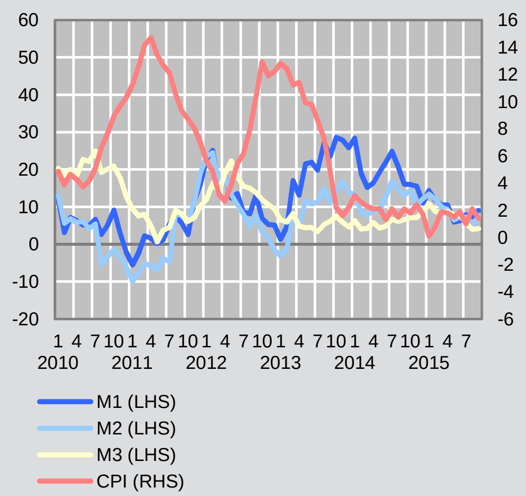
In terms of the composition of dinar reserve money, overnight bank deposits with the NBS decreased the most (RSD 25.7 bln). Dinar allocations of required reserves contracted by RSD 5.0 bln, and vault cash by RSD 0.6

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

	2014	2015			Share in M3 Sept. 2015 (%)
	Dec.	March	June	Sept.	
M3	6.8	6.5	5.8	2.7	100.0
FX deposits	5.2	5.9	6.1	10	66.6
M2	10.3	7.9	5.2	6.2	33.4
Time and savings dinar deposits	13.2	6.7	7.5	3.0	9.4
M1	9.1	8.4	4.3	7.6	24.0
Demand deposit	11.1	11.7	5.4	10.6	17.3
Currency in circulation	4.8	11	17	0.4	6.6

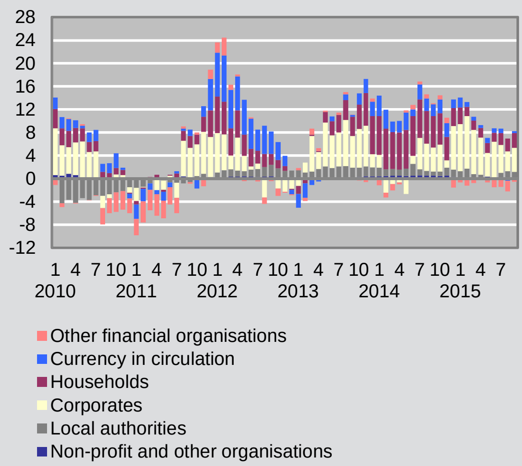
Source: NBS.

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



Sources: SORS and NBS.

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



Source: NBS.

bln. Bank gyro account balances gained RSD 11.2 bln, currency in circulation RSD 6.7 bln, and balances on accounts of local governments and other sectors RSD 0.3 bln.

Money supply, primarily its dinar component, increased in real terms in Q3. Higher corporate and household transaction, savings and time deposits pushed M1 and M2 up by 6.9% and 6.3% in real terms, respectively. Thus, despite a drop in FX deposits, M3 gained 1.0%. Y-o-y, money supply growth accelerated in Q3. As a result, M1, M2 and M3 were 7.6%, 6.2% and 2.7% higher in real terms in September relative to the same period last year.

After a longer interval, lending to the private sector provided an impulse to M3 creation. Increased investment of banks in government securities worked in the same direction, but its impact was moderated by higher government deposits with the NBS. Banks' net foreign assets declined (foreign receivables went down and foreign obligations up), resulting in M3 withdrawal.

A breakdown by M3 component shows that demand deposits increased the most in Q3 (RSD 22.0 bln). For the largest part, this increase was generated in company accounts, mainly in the energy, trade and transport sectors, as well as in households' accounts. At the same time, longer-term dinar deposits gained RSD 8.4 bln, mostly on account of an increase in corporate, OFO and household accounts.

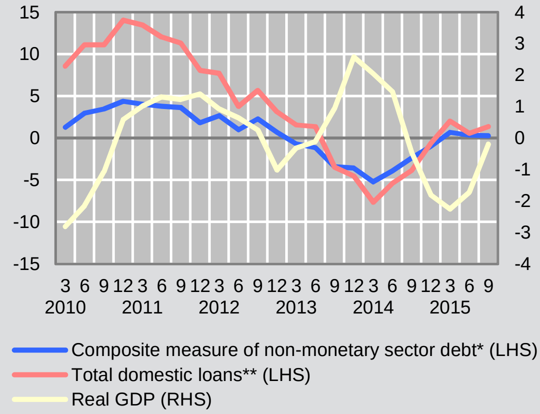
Protracted low and stable inflation, higher interest rates and preferential tax treatment of dinar relative to FX savings contributed to an increase in dinar household savings in Q3. In September, they reached a historical high of RSD 42.0 bln. They gained RSD 2.0 bln relative to June, with households opting most for demand and one- to five-year time savings deposits. By contrast to dinar savings, household FX savings decreased by EUR 65.9 mln down to EUR 8.3 bln in late September.

Loans

Past monetary easing and the consequent drop in lending rates contributed to an improvement in lending market trends in Q3 from earlier quarters. Lending picked up in June and continued to rise over the coming months, recording, for the first time this year, a 1.2% rise in Q3, excluding the exchange rate effect[11]. Both household and corporate lending went up. Still, relative to June, the share of domestic loans to estimated GDP declined by 0.2 pp down to 47.8% in September.

In y-o-y terms, after stagnating in July, growth in total domestic lending picked up to 1.3% in September.

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

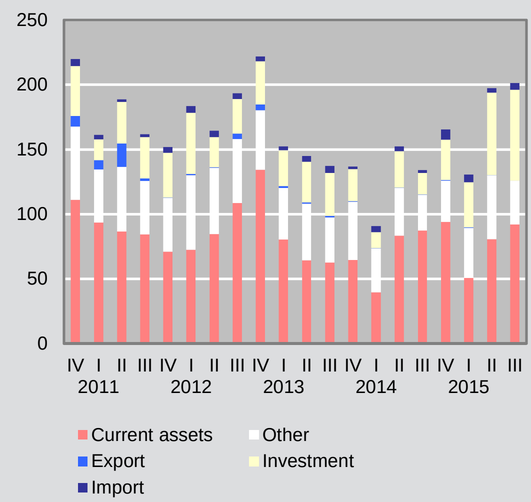


Sources: NBS and SORS.

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

** Excluding the exchange rate effect.

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



Source: NBS.

[11] Calculated at the dinar exchange rate against the euro, Swiss franc and US dollar as at 30 September 2014 (the so-called programme exchange rate used for the purpose of monitoring the IMF arrangement), according to the currency composition of loan receivables.

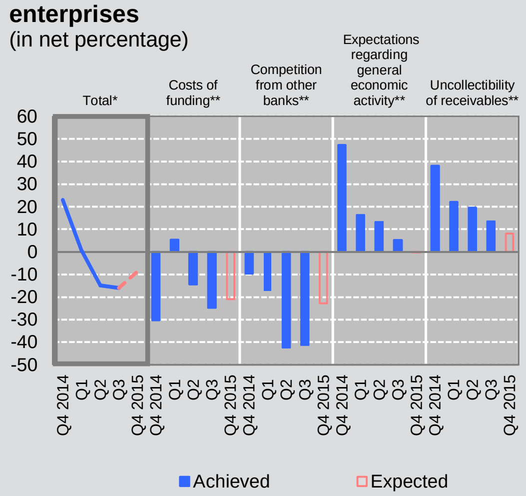
Corporate loans increased by 1.7%, y-o-y, and household loans by 2.5%, y-o-y.

Excluding the exchange rate effect, corporate loans gained 1.4% or RSD 15.6 bln in Q3, as lending to companies went up (RSD 26.6 bln), while claims on public enterprises contracted by RSD 10.9 bln. New corporate loans increased from Q2, with the share of refinanced loans, i.e. loans with amended terms of repayment, down to a quarter of new loans. Maturing subsidised dinar loans for current assets were compensated for by new, mostly FX-denominated loans. Investment loans made up 35% of new loans in Q3, signalling that rising private investment recorded this year is also financed from bank lending. This is also supported by data on the value of new investment loans, which at RSD 168.8 bln were almost three times higher in the first nine months of 2015 than in the same period a year earlier. In terms of loan users, investment loans increased across different sectors, with largest loan amounts approved to enterprises in the agriculture, food, telecommunications and energy sectors. This rise is also favourable in terms of lengthening of the maturity of the loan portfolio, with the share of loans maturing in over two years up from 57.5% in late 2014 to 63.6%.

The results of the October bank lending survey[12] were consistent with expectations stated in the prior survey with regard to continued relaxation of standards and rising corporate demand in Q3. Banks reported similar expectations for Q4. According to banks, standards were relaxed for both dinar and FX loans in Q3, mostly due to competition among banks and cheaper sources of funding, while risks relating to collection of receivables and growth prospects persisted, but were more moderate. As banks reported, margins and associated costs continued to decline in Q3, and repayment terms were lengthened. Requirements regarding collateral and maximum loan amount were relaxed for the first time. Demand by small and medium, as well as large enterprises, went up, motivated mostly by the need to finance current assets and restructure existing debts. The same factors are expected to drive demand in Q4. For the first time since the survey began, a number of banks also expected investments to give a positive impulse to loan demand.

Household loans continued up, rising by 1.3% or RSD 8.7 bln in Q3, excluding the exchange rate effect. The volume of new loans was somewhat lower than in Q2. However, it should be noted that a part of new loans in Q2 were

Chart IV.2.5 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to enterprises**
(in net percentage)

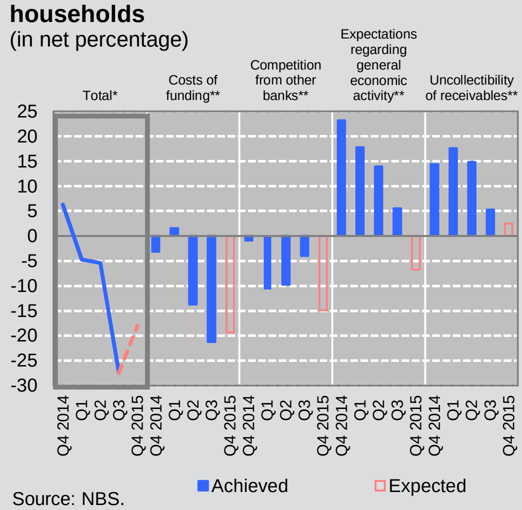


Source: NBS.

* Positive values indicate tightening and negative easing of credit standards relative to the previous quarter.

** Positive values indicate the contribution of individual factors to tightening, and negative values indicate the contribution to easing of credit standards.

Chart IV.2.6 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to households**
(in net percentage)



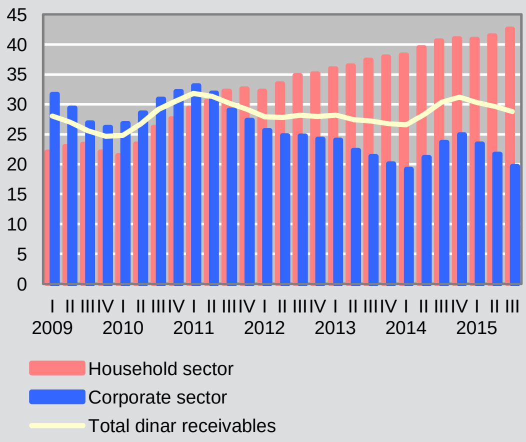
Source: NBS.

* Positive values indicate tightening and negative easing of credit standards relative to the previous quarter.

** Positive values indicate the contribution of individual factors to tightening, and negative values indicate the contribution to easing of credit standards.

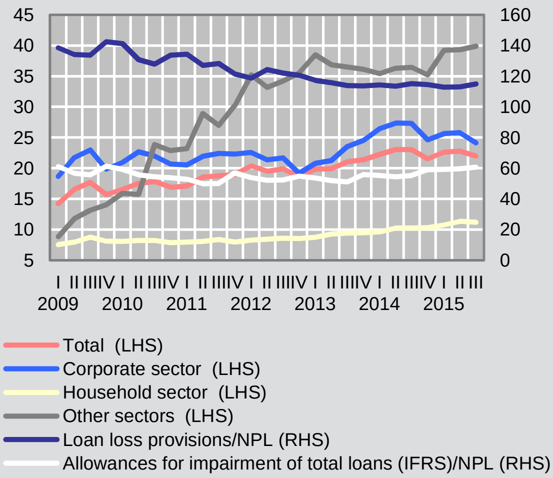
[12] The NBS has conducted the survey since early 2014. Participation is voluntary and the response rate almost 100%.

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



Source: NBS.

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



Source: NBS.

Swiss franc-indexed loans with terms of repayment modified in line with the NBS Decision on measures for preserving stability of the financial system in the context of foreign currency-indexed loans. As before, households opted most for cash loans, which made up more than a half of new loans (54%), while around 21% of new loans were housing loans and around 20% were other loans. With regard to costlier loan categories, the use of revolving loans increased, while borrowing on credit cards and current account overdrafts was broadly flat from the prior months.

According to the bank lending survey, Q3 increase in household loans was bolstered by relaxed lending standards and higher demand. Standards were relaxed for all loan categories, for the same reasons as in the case of corporate loans. To attract new clients, banks cut interest rate margins and associated costs further. A number of banks also relaxed requirements with regard to collateral, while other terms were not changed. In line with banks' earlier expectations, household demand went up and related mostly to refinancing of existing obligations, but also to purchase of real estate and consumer durables. Banks expect a further easing of standards and an increase in loan demand in Q4.

The share of dinar loans in total corporate and household loans declined by 2.4 pp from end-2014 to 28.8% at end-September. The degree of dinarisation of corporate lending fell to 19.6% at end-Q3 due to the maturing of dinar subsidised loans and an increase in new FX-denominated loans. By contrast to the corporate sector, households mostly borrowed in the currency of their income. The dinarisation of household lending continued up to reach 42.6% in September.

According to survey responses, uncollectible receivables continue to be the key factor hindering relaxation of credit standards. As the implementation of the NPL Resolution Strategy[13] ought to provide a market-based, sustainable solution to this problem, positive effects could be expected in the coming period.

In Q3, the share of NPLs in total loans, on a gross basis, shrank by 0.8 pp to 22.0% in September. This was due to a mild increase in lending activity, but also to collection, write-off and restructuring of a part of NPLs. The amount of total NPLs in banks' balance sheets was RSD 16.5 bln lower than in June. The share of corporate NPLs declined by 1.6 pp to 24.1%, and the share of household NPLs by 0.2 pp to 11.1%[14]. However, despite the high share of NPLs in total loans, the capital adequacy ratio of 21.2% and the results of macroprudential stress tests indicate that the stability of the domestic banking sector is not impaired. In September, allowances for impairment of total loans

[13] The National Bank of Serbia participated in the production of this strategy, which was adopted by the Government of the Republic of Serbia in August.

[14] With entrepreneurs and private households included, the share fell by 0.2 pp to 12.0%.

amounted to 60.8% of NPLs, which is higher than in June, and loan loss provisions,[15] at 115.0% in September, continued to fully cover the amount of gross NPLs.

3. Real estate market

The stock of real estate supply increased in Q3 following regulatory improvements in the area of construction, while lower costs of funding drove demand up. This, coupled with lower prices, pushed up turnover in the real estate market for the first time this year.

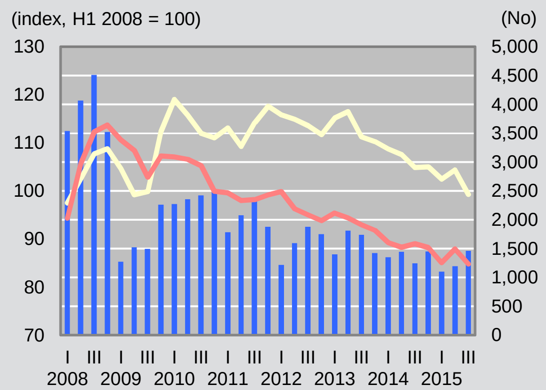
After a temporary break in Q2, the downward trend in Serbia's real estate prices continued into Q3, with DOMex[16] down by 4.9%. Prices fell across all regions, except in South and East Serbia, with the decline particularly sharp in Vojvodina. Y-o-y decrease in real estate prices also continued (5.3%).

The average real estate price in Serbia fell to EUR 823.1 per square meter in Q3, close to its pre-crisis level[17]. The ratio of average real estate price in Belgrade relative to the rest of Serbia continued to hover around its two-year average (1.8), despite a mild decline in Q3. Lower prices drove up turnover,[18] which rose by 22.5% in Q3, nearing its end-2014 level. Turnover increased across all regions, also rising in y-o-y terms after two quarters.

In addition to lower prices, turnover growth was also bolstered by reduced costs of financing resulting from trimmed interest rates on housing loans since the start of the year. Despite the low purchasing power, prospective buyers were increasingly interested in housing loans, as confirmed by the results of the October bank lending survey, according to which real estate purchases were one of the key factors behind increased loan demand.

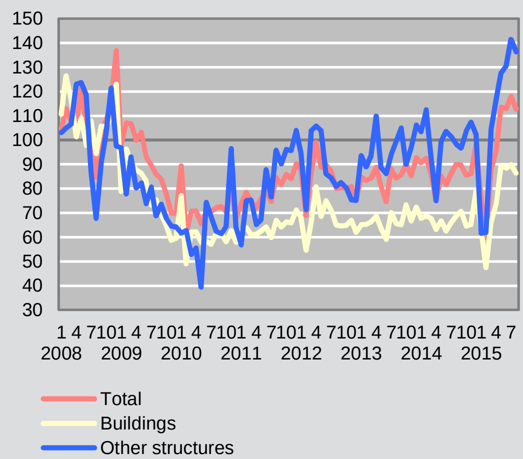
The simplified construction permitting process continued to have a positive impact on the stock of real estate supply. The number of issued construction permits increased by around 30.0% in the July-August period relative to the same period a year earlier. As a result of regulatory changes in this area, Serbia's ranking in the World Bank's Doing Business Report[19] improved. This ranking may improve still further in the coming year after the expected introduction of an electronic construction permit.

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



Source: National Mortgage Insurance Corporation.

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



Sources: SORS and NBS calculation.

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

[16] DOMex is published by the National Mortgage Insurance Corporation and relates only to real estate purchased by insured loans. Though it does not monitor purchase/sale transactions financed by own funds or uninsured loans, DOMex is judged to mirror trends in the real estate market, considering high unemployment levels, declining wages and muted lending activity.

[17] Level from H1 2008.

[18] The number of real estate transactions and flat prices per square meter also relate only to real estate purchased by insured loans.

[19] See: text box 1, p. 30.

4. Aggregate demand

Reforms of the business environment, coupled with improved financial position of enterprises attributable chiefly to the drop in oil prices and lower costs of borrowing, reflected positively on the growth of private fixed investment in Q3. The drop in oil prices and lower costs of borrowing mitigated short-term negative effects of fiscal consolidation on final consumption. On the other hand, due to the shrinking of real exports of goods and services and an upswing in imports of equipment, net external demand was a negative contributor, pulling GDP down (0.4% s-a).

Private investment and exports were again the main drivers of a 2.0% y-o-y rise in GDP in Q3. On the other hand, final consumption of households and government, which continued to fall in y-o-y terms, remained negative contributors to GDP.

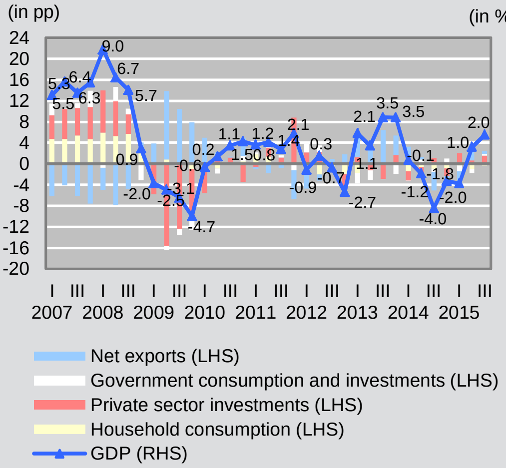
Domestic demand

Household consumption continued up in Q3 (0.4% s-a), giving a positive impetus to GDP of 0.3 pp and slowing its y-o-y fall further down to 0.5%. An increase in household consumption is indicated by a larger retail trade turnover in Q3 (2.3% s-a), higher imports of consumer goods (0.8% s-a) and more generous VAT revenues (1.5% s-a).

The main sources of consumption also increased in Q3. As the net wage bill in real terms inched up by 0.7% s-a, continued increase was recorded for social insurance transfers (0.6% s-a) and the newly approved consumer and cash household loans. On the other hand, the inflow of remittances subsided relative to Q2, whilst rising y-o-y.

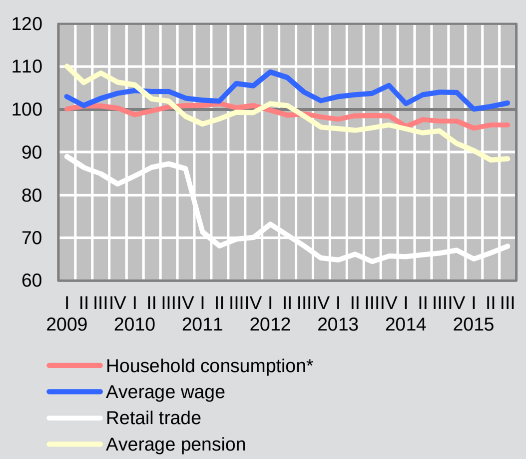
Improved investment environment, brought about by the reforms undertaken over the last two years, and continued positive effects of low oil prices and lower interest charges on financial position of businesses contributed to an unbroken growth of **private investment** extending into Q3 (1.2% s-a), which gave a positive contribution to GDP (0.2 pp). This is signalled mainly by a further rise in imports of equipment (2.4% s-a in Q3), which in the first nine months of the current year posted 15.6% y-o-y growth. Positive trends in private investment are also signalled by construction indicators – number of construction permits issued and effective hours worked in construction continued up in Q3, while production of

Chart IV.4.1 **Contributions to y-o-y GDP growth rate – expenditure side**



Sources: SORS and NBS calculation.
Note: NBS estimate for Q3 2015.

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



Sources: SORS and NBS calculation.
* NBS estimate for Q3 2015.

construction material, characterised by a robust growth in Q2, went into stagnation. Private investment continued to grow in y-o-y terms as well (11.2%), at a similar pace as in the quarter before, giving a positive contribution to GDP of 1.9 pp.

In terms of investment financing, Q3 saw increased approval of investment loans across a large number of sectors of the economy, which confirms that the nascent growth of investment activity is broad-based. Net FDI inflow also went up, mostly in equity capital.

Increasing at an estimated 0.6 % s-a, final **government consumption** also gave a positive contribution to GDP (0.1 pp) in Q3. Similarly to the quarter before, government consumption rose on the back of higher expenditures for the purchase of goods and services, while public sector wage expenditures shrank. Y-o-y, the fall in government consumption continued to slow down in Q3 (1.5%). Public sector wage expenditures declined in real terms by 11.6% y-o-y in the first nine months of 2015.

Although **government investment** recorded a rather modest growth (2.1% s-a), it followed an extremely robust upswing in Q2 and points to continued intensive implementation of infrastructure project works. Y-o-y, this component of demand gained 24.8% in Q3 after two consecutive quarters of decline, thus adding 0.6 pp to GDP.

Table IV.4.1 **Investment indicators**

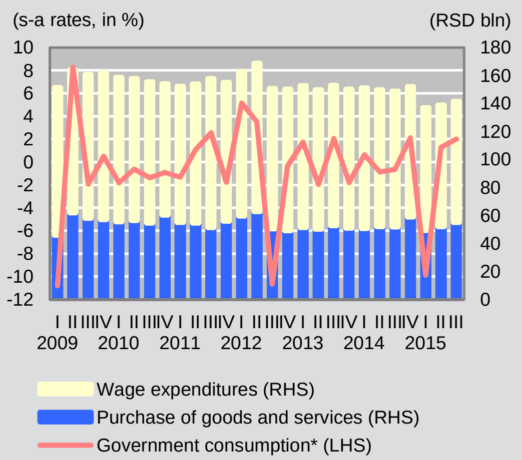
	2014		2015		
	III	IV	I	II	III
Real indicators (seasonally-adjusted, quarterly growth, in %)					
Industrial inventories	-2.0	-15	5.3	-0.5	10
Industrial production of capital goods	18	-3.0	14.8	-5.7	-9.1
Exports of equipment*	-2.5	-12	30.5	-5.2	5.1
Imports of equipment*	3.8	16	4.6	3.9	2.4
Inventories of capital goods	19	6.2	3.2	2.9	-5.0
Industrial production of intermediate goods	19	-0.1	4.5	10	-0.5
Exports of intermediate goods*	0.1	17	3.0	4.6	16
Imports of intermediate goods*	-0.3	15	6.2	15	0.6
Inventories of intermediate goods	-0.5	-0.7	-0.3	2.2	-0.6
Industrial production of construction materials	3.9	2.9	-8.9	8.6	-0.1
Inventories of construction materials	-2.7	-15	-2.5	-4.8	-6.6
Government investment**	-35.2	5.7	-19.8	49.6	2.1

Sources: SORS and NBS calculation.

* Exports and imports are denominated in euros.

** Government investment spending is deflated by the industrial producer price index.

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



Sources: SORS, Ministry of Finance and NBS calculation.

* NBS estimate for Q3 2015.

Net external demand

Following three consecutive quarters of growth, in Q3 goods and services exports lost 2.3% s-a in real terms, pushing GDP down by 1.1 pp. Lower exports reflect a drop in commodity exports, while exports of services continued up. Imports of goods and services recorded a real fall in Q3 (1.3% s-a), giving a 0.8 pp positive contribution to GDP.

Relative to the same period a year earlier, Q3 saw real exports of goods and services continuing up at a similar pace as in H1 (7.8%), giving a positive 3.4 pp contribution to GDP. On the other hand, though growth in nominal imports slowed down, lower external prices contributed to the acceleration of growth in real imports of goods and services to 5.1% y-o-y in Q3.

Q3 witnessed deterioration in cost competitiveness, measured by unit labour costs in manufacturing, as well as in price competitiveness, due to nominal appreciation of the effective exchange rate of the dinar and a more pronounced drop in external compared to domestic prices. Indicator of external demand[20] continued up third quarter in a row, though at a slower pace than in Q2, which could partly account for the drop in commodity exports in Q3.

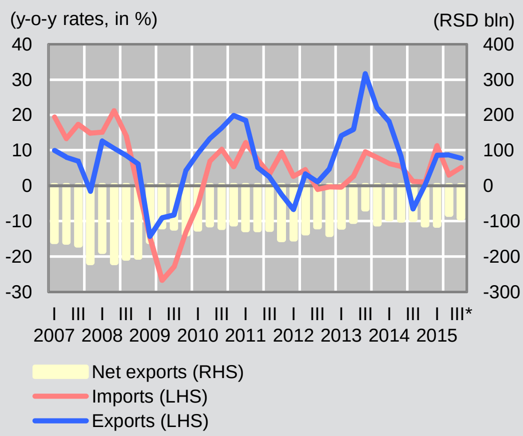
After a robust growth in H1, indicated, inter alia, by a y-o-y upswing in the majority of export-oriented branches of manufacturing industry, euro-denominated commodity exports lost 4.2% s-a in Q3. The fall was mainly driven by lower exports of motor vehicles (2.2 pp). Nevertheless, Fiat remained the largest single exporter, posting EUR 209.3 mln of exports in Q3. In the first nine months of 2015 total exports of the company reached EUR 944.3 mln, recording a 11.6% y-o-y drop. This indicates that markets are gradually becoming saturated with the current automobile model, given that sales of new automobiles are on the rise in our major export markets.

Apart from motor vehicles, commodity exports were held back primarily by lower exports of agricultural products. Corn exports subsided the most, as a result of higher domestic relative to external prices, an increase in exporters' costs caused by higher port taxes and the fact that the major portion of the market surplus of corn from the previous mercantile year was exported in the period October 2014–June 2015 (2.8 mln tons). As expected, wheat exports rose relative to Q2 when the new harvest reached the market, while declining by around 10% y-o-y, as a result of a relatively high domestic price, similarly as in the case of corn. On the other hand, higher production of major exporting fruits (apple and raspberry) in the current season was reflected in a 21.4% y-o-y increase in fruit and vegetable exports in Q3.

Q3 also saw a decline in exports of base metals due to the drop in steel and copper prices in the global market. Nevertheless, exports of Smederevo steel plant rose by 80% in y-o-y terms in the first nine months of 2015, reaching close to EUR 250 mln.

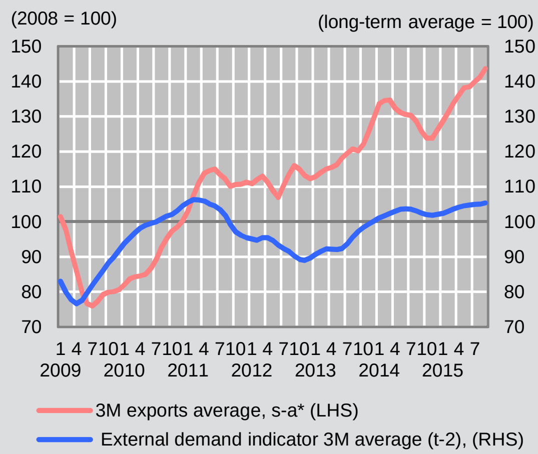
As for commodity exports, which are primarily determined by movement in external demand[21], the fall is significantly lower, at 0.3% s-a. A decline in exports was recorded in food, chemical and textile industries, as well as in production of metal and rubber and plastic products.

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 for Q3 2015.

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



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

[20] 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.

[21] After excluding the exports of agricultural products, oil and gas, electricity, Fiat, Smederevo Steel Plant and HIP Petrohemija.

On the other hand, an increase in exports was recorded for electrical equipment, petroleum products and power machinery and appliances.

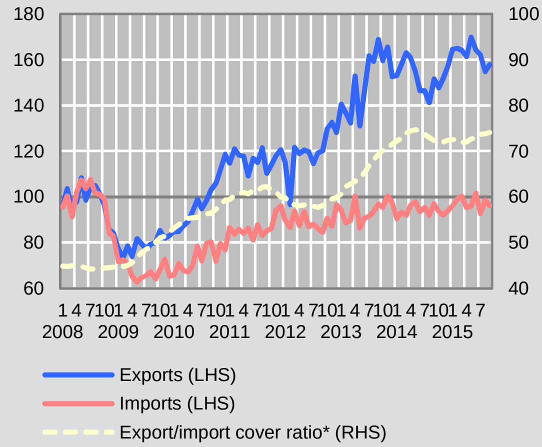
Speaking of services exports, tourist services rose the most, as indicated by higher turnover in catering and the number of overnight stays of foreign tourists in Q3. In addition, exports of transport services also increased, chiefly owing to continuation of high growth of turnover in air transport. Exports of telecommunication, computer and information services, which hold a significant place in the structure of services exports, were at a similar level as in Q2.

Euro-denominated commodity imports also declined in Q3 (1.9% s-a), pushed down by lower imports of intermediate goods. On the other hand, equipment imports continued up, though at a somewhat slower pace than in H1. As opposed to the previous quarter, imports of consumer goods also edged up mildly.

Observed by economic destination of the EU, the greatest contribution to the fall of commodity imports, similarly to the previous quarter, came from energy imports. Oil imports continued to decline in Q3 reflecting the continued drop in global oil prices, while imports of natural gas stayed roughly the same, despite the price drop, which indicates higher gas consumption in industry. Electricity imports went down in Q3 as well, as domestic production fully recovered from flood

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

(s-a data, H1 2008 = 100) (%)

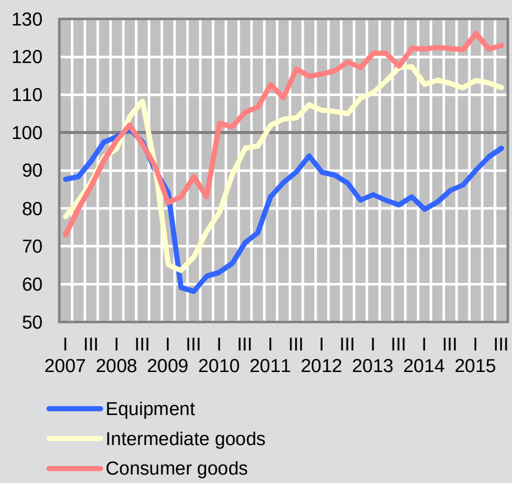


Sources: SORS and NBS calculation.

* 12-month moving average.

Chart IV.4.6 **Imports by key components**

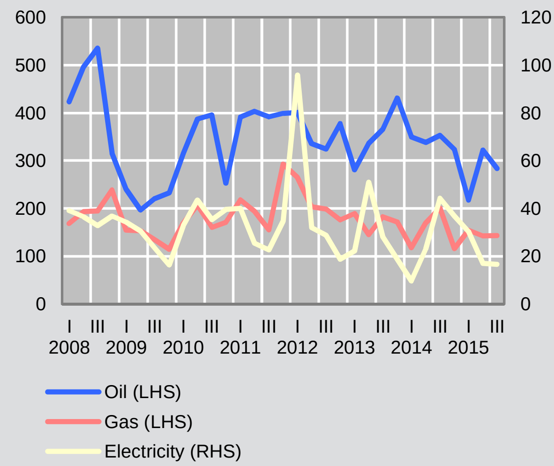
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Chart IV.4.8 **Energy imports**

(s-a data, EUR mln)



Sources: SORS and NBS calculation.

consequences. Apart from imports of energy, imports of capital goods also continued to shrink. Same as in Q2, this was brought about by lower imports of automobiles and components in automobile industry. As for consumer goods, imports of non-durable consumer goods increased, primarily of seasonal clothing and footwear, while imports of durable consumer goods were weighted down by lower imports of electrical machinery and appliances, telecommunication and audio appliances and equipment.

Experiencing a drop in Q3, commodity exports returned close to their end-2014 level in September, i.e. 57.9% above the pre-crisis level[22]. On the other hand, commodity imports throughout Q3 remained below their pre-crisis level and were 3.8% below this level in September. Commodity export/import cover ratio edged up by 1.2 pp in Q3, to 74.1% in September.

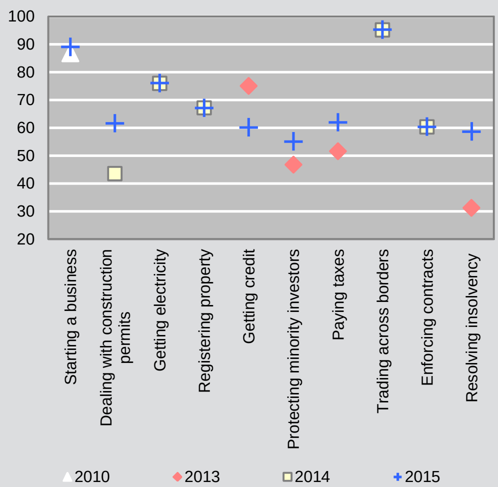
[22] H1 2008.

Text box 1: Serbia's competitive position according to recent global competitiveness indicators

Late in October, the World Bank published its Doing Business 2016 report, measuring the ease of doing business in 189 countries, i.e. indicating how easy or difficult it is for a local entrepreneur to set up and operate a small or medium-sized enterprise, while adhering to pertinent regulations. Based on legislation analysis and contacts with the private sector and government officials in the countries observed, the report measures and registers changes in regulations affecting 11 areas of the life cycle of a business: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts, resolving insolvency and labour market regulation.[1] The results are presented in terms of two aggregate measures: distance to frontier score (where 100 is the best and 0 the worst performance) and based on it, ease of doing business ranking. In comparisons over time, distance to frontier shows how much the economy's regulatory environment has changed from the standpoint of local entrepreneurs, while ranking shows how much the regulatory environment has changed relative to that of other countries. Although the methodology of Doing Business, like any other methodology, has its limitations (observes only limited liability companies operating in the largest business city of an economy, does not capture all the relevant areas of doing business, i.e. the proximity to large markets, quality of infrastructure services, macroeconomic conditions etc.), it may definitely serve as a starting point in identifying reforms that are necessary in order to improve the conditions of doing business in a particular country.

According to Doing Business report, Serbia ranks 59th among 189 countries observed, nine places up from the year before[2]. On the distance to frontier metric, Serbia's score is 68.41, up by 3.16 pp relative to 2014. Though still ranked relatively low compared to other European countries, Serbia is among this year's 15 best performers according to the progress achieved. Of the ten areas observed, the greatest progress was recorded in issuance of construction permits and ease in paying taxes, where its ranking improved by 39 and 22 places respectively, while the distance from frontier was reduced by 17.95 pp and 12.97 pp. These are at the same time the areas in which Serbia ranks the worst (139th and 143rd place), but the distance from frontier is now reduced to below 40%. Serbia's lagging behind the "best practice" is the greatest in the area of protection of minority investors (45%) and the smallest in cross-border trade (5%). At the same time, trading across borders is the area in which our country performed the best (23rd place).

Chart O.1.1 **Change in Serbia's distance to frontier[3]**
(%)



Source: http://www.doingbusiness.org/.

Therefore, Serbia achieved the greatest progress in construction permits issuance and payment of taxes. Even so, permits issuance is still subject to a relatively large number of procedures (18) and requires a considerable length of time (272 days). The process of obtaining a construction permit has long been recognised as one of the main obstacles to attracting foreign capital to Serbia. Recent legislative changes represent a step forward, i.e. they have reduced the costs of obtaining a permit. Speaking of paying taxes, the procedure was simplified for companies by the introduction of an electronic system for filing and paying value added tax and social

[1] Labour market regulation data are provided in Annex to the Report.

[2] It should be noted that in the last year's World Bank report we were ranked 91st, but after methodological changes and revision of last year's data, our comparable ranking for 2014 considerably improved (68th).

[3] Due to methodological changes in 2014 and 2015, distance from the "best practice" is not comparable across all years. Therefore, data in areas of getting credit, protecting minority investors, paying taxes and resolving insolvency are comparable as of 2013, while data in areas of dealing with construction permits, registering property, trading across borders, enforcing contracts and getting electricity are comparable as of 2014. Given that in the meantime no methodological changes were recorded in the area of starting a business, those data are comparable since 2010.

insurance contributions as well as by the abolishment of the urban land usage fee. Furthermore, in the last few years Serbia has made significant steps forward in resolving insolvency by undertaking legislative changes. These changes primarily shortened the length of the bankruptcy procedure (from 2.7 to 2.0 years), introduced unified reorganisation procedure, stipulated professional requirements for insolvency administrators, regulated their remuneration, etc.

In the latest World Economic Forum's Global Competitiveness Report Serbia kept 94th place (on the rank list of 140 countries), while its global competiveness index (GCI)[4] (3.89) dropped negligibly (0.01) from the year before. Relatively small changes in value were recorded compared to the last year under majority of GCI pillars. Serbia scored greatest improvements in the areas of health and primary education and macroeconomic environment, while experiencing deterioration in terms of financial market development. Improvement in Serbia's macroeconomic environment was recorded for inflation (measured as the average annual rate) as the country moved in a shot from 127th to 1st position in terms of this criterion. Serbia shares this position with another 42 countries, since best performers boast average annual inflation rate ranging from 0.5 to 2.9 percent (under this criterion, deflation and high inflation are considered equally detrimental for the economy). In view of inflation movements in the first nine months of 2015 and the projection until end of year, it is likely that Serbia will keep the first position under this criterion in the coming year as well. Further improvement under the pillar Macroeconomic environment in the next year is expected also on account of a sizeable reduction of budget deficit achieved this year. Speaking of the pillar Financial market development, respondents assessed most unfavourably the availability of venture capital and ease of access to loans. Lower value of this pillar relative to the last year resulted chiefly from the lower value of the legal rights index[5], while the respondents also gave a slightly less favourable assessment of bank soundness and regulation of the securities exchanges. Nevertheless, bank soundness remains the best performing indicator under this pillar. Respondents are of the opinion that, relative to the year before, certain improvements are visible in financing through the local equity market.

Pillar-wise, the lowest value is assigned to innovation (2.90) and business sophistication (3.14), and the highest to health and primary education (5.87) and technological readiness (4.47). Under the last two pillars Serbia also achieved its best results and was rated on the upper half of the list – in 51st place in technological readiness and in 62nd in health and primary education. On the other hand, Serbia ranks very low in the areas of goods market efficiency and business sophistication – 127th and 132nd place, respectively.

In the area of labour market efficiency, the value of the pillar remained almost unchanged (reduction by 0.01), despite the fact that legislative changes (extension of a maximum duration of definite term contract from one to two years, introduction of more flexible forms of work – work at home and reduced working hours, stipulation that severance pay and calculation of years of service shall take into account only the years of employment with the last employer and that the base for calculation of subsidy for annual holiday shall include only the basic salary, excluding any additions etc.) created preconditions for more flexible labour market flows and reduced the costs of hiring and lay off. This leads to conclusion that the effects of the abovementioned changes have not taken root yet and that they should become visible in the period ahead.

The World Economic Forum has published the Global Competitiveness Index (GCI) since 2005. The index is composite by nature and is calculated as a weighted average of a large number of different indicators (a total of 114 indicators) capturing different aspect of competitiveness. The indicators are grouped under 12 competitiveness pillars which are organised in three groups – basic requirements, efficiency enhancers and innovation and sophistication factors. Depending on a development phase of a country (production factor, efficiency or innovation-driven growth), those three

[4] Global Competitiveness Index.

[5] This index is monitored and published by the World Bank. It measures the degree to which laws on collateral and bankruptcy protect the rights of borrowers and lenders and thus facilitate lending.

Table O.1.1 **Global Competitiveness Index for Serbia**

	Index value		Change in 2015		Ranking in 2015
	2014	2015	size	direction	(140 countries)
Global Competitiveness Index	**3.90**	**3.89**	**-0.01**	↘	**94**
Basic requirements (40%)	***4.10***	***4.15***	***0.04***	↗	***96***
1st pillar: Institutions	3.21	3.24	0.03	↗	120
2nd pillar: Infrastructure	3.93	3.87	-0.06	↘	75
3rd pillar: Macroeconomic environment	3.51	3.60	0.09	↗	125
4th pillar: Health and primary education	5.76	5.87	0.11	↗	62
Efficiency enhancers (50%)	***3.90***	***3.85***	***-0.04***	↘	***83***
5th pillar: Higher education and training	4.25	4.27	0.01	↗	71
6th pillar: Goods market efficiency	3.78	3.74	-0.04	↘	127
7th pillar: Labor market efficiency	3.73	3.72	-0.01	↘	118
8th pillar: Financial market development	3.50	3.23	-0.27	↘	120
9th pillar: Technological readiness	4.45	4.47	0.02	↗	51
10th pillar: Market size	3.68	3.70	0.02	↗	75
Innovation and sophistication factors (10%)	***3.05***	***3.02***	***-0.03***	↘	***125***
11th pillar: Business sophistication	3.21	3.14	-0.07	↘	132
12th pillar: Innovation	2.89	2.90	0.01	↗	113

Source: World Economic Forum.

groups are assigned different weights in calculation of the aggregate index. Since Serbia belongs to countries whose growth is driven by efficiency enhancers, the greatest weight (50%) and consequently significance in determining Serbia's competitiveness is assigned to pillars in the second group. Each pillar, same as GCI itself may take values on a scale of 1-7, where higher value signifies also a higher degree of competitiveness.

Although Serbia's competitiveness according to the GCI is not most favourable, it should be borne in mind that this indicator largely reflects the views of businessmen doing business in a country concerned and therefore comprises the subjective element. Namely, though calculation relies on statistical data (such as inflation rate, public debt level, number of days needed to start a business etc.), around 70% of indicators entering the GCI are actually the so called soft indicators, seeking to capture qualitative aspects of competitiveness. As internationally comparable databases for these indicators are not available, they are obtained based on a survey which the World Economic Forum conducts once a year, requiring respondents to assess the given indicator on a 1-7 scale (e.g. effects of taxation on investment incentives, affordability of financial services etc.). For example, in the area of labour market efficiency, eight of the ten indicators observed are obtained based on the survey.

5. Economic activity

Following strong growth in the previous three quarters, industrial production subsided in Q3 as anticipated, which was a major factor behind a mild GDP fall of 0.4% s-a. Owing to the full recovery of production in mining and energy sectors and continued positive trends in construction, Q3 posted further y-o-y growth in GDP, which according to the flash estimates of the Serbian Statistical Office equalled 2.0%.

According to the NBS estimate, GDP growth in 2015 should amount to 0.8%, up by 0.3 pp from the previous projection. The upward revision was motivated by better performance in the construction sector and lesser than expected contraction of agricultural production.

The recovery of production in mining and energy in H1 helped industrial production return to its pre-flood levels, while favourable trends in manufacturing pushed it even beyond that. Hence, some shrinking of industrial production in Q3 (2.3% s-a) was expected and was one of the major factors driving a GDP decline of 0.4% s-a. The fall in activity was recorded in agriculture and the majority of service sectors, while construction continued up. Despite a mild decline in Q3, GDP continued to trend close to its pre-crisis level[23] (0.8 pp below), while economic activity, measured by NAVA, was 0.2 pp below from where it stood before the crisis.

Q3 saw a further GDP growth in y-o-y terms, measuring 2% according to the flash estimate of the Serbian Statistical Office. Industry and construction remained positive contributors to y-o-y GDP growth, while due to this year's drought and good season last year, agriculture gave a negative impetus. In the majority of service sectors a y-o-y fall in activity continued, except in trade, transport and catering, which recovered mildly.

A contraction of industrial production in Q3 resulted from lower activity in manufacturing and electricity, gas and steam supply, while mining marched in place. Lower physical volume of production in electricity, gas and steam supply (4.9% s-a) was expected, given that Q2 saw a bounce back and even outperformance of the pre-flood production levels. Consequently, the physical volume of coal production also went down (8.1% s-a), while coal inventories reached their record high. Though coal production subsided, physical volume of production in mining stagnated in Q3 owing to increased exploitation of metal ores (12.9% s-a). Y-o-y, mining and electricity, gas and steam supply continued to record growth in physical volumes due to the efect of the low base (30.2% and 41.1%, respectively).

The physical volume of production shrank in the manufacturing sector as well (2.2% s-a). The main negative contributor was motor vehicle production, which suffered from several interruptions in Q3, due to

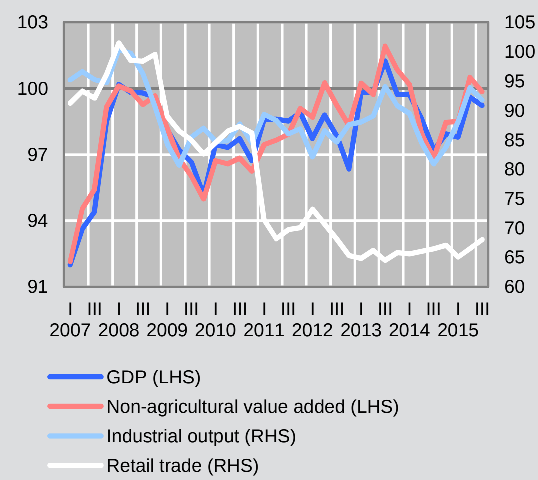
Table IV.5.1 **Annual GDP growth and contributions**

	2013		2014		2015*	
	%	pp	%	pp	%	pp
GDP	**2.6**	**2.6**	**-1.8**	**-1.8**	**0.8**	**0.8**
Agriculture	20.9	1.5	0.8	0.1	-8.0	-0.7
Industry	6.0	1.2	-7.1	-1.5	7.9	1.6
Manufacturing	5.7	0.8	-1.7	-0.3	5.5	0.8
Mining and energy	8.8	0.4	-21.3	-1.0	16.6	0.8
Construction	-3.9	-0.2	0.9	0.0	8.0	0.3
Services	0.3	0.1	-0.5	-0.2	-1.2	-0.5
Net taxes	-1.1	-0.2	-0.6	-0.1	0.6	0.1

Sources: SORS and NBS calculation.

* NBS estimate.

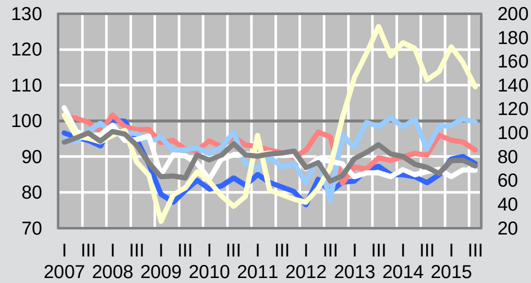
Chart IV.5.1 **Economic activity indicators**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

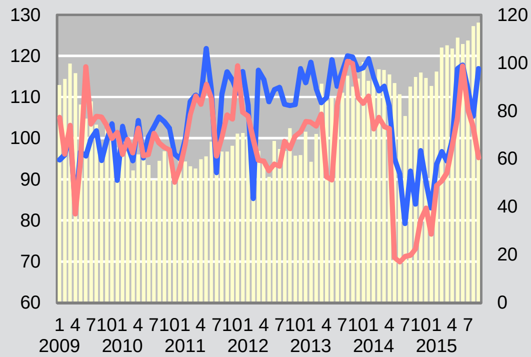
[23] H1 2008.

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



Sources: SORS and NBS calculation.

Chart IV.5.3 **Physical volume of production in energy and mining**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

collective vacation in Fiat factory, and lower market demand for the Kragujevac-produced model. Further shrinking of physical volume was also recorded in the production of metal products, machinery and equipment and in food industry, while chemical industry and production of petroleum products declined after two consecutive quarters of growth. However, it is estimated that contraction in food production does not primarily stem from lower demand, since Q3 saw over 10% s-a fall in food product inventories in September. On the other hand, positive trends continued in the production of electrical equipment, beverages, pharmaceutical and tobacco products.

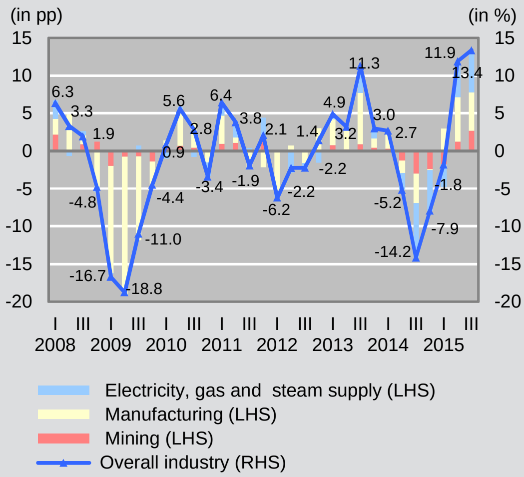
Negative contribution to GDP in 2015 is expected from agriculture, since drought dented corn and industrial plant yields. Nevertheless, judging on the whole, agricultural output is likely to contract less than initially expected. According to the latest estimate of the Serbian Statistical Office, corn yields are likely to drop by around 30% y-o-y, instead of 50%, and industrial plant yields by around 20%, instead of 35%. Higher than expected corn supply should give impetus to livestock production, as confirmed by the indicator movements since the start of the year. Bearing this in mind, instead of the initially expected 10%, the fall in agricultural output should amount to some 8%, and give a negative 0.7 pp contribution to GDP.

A positive contribution to GDP is expected from the construction sector, both in Q3 (0.7 pp) and on an annual basis (0.3 pp). A pick-up in activity of this sector is signalled primarily by the growth in value of completed works (12.7%) and the hours worked at construction sites (3.5% y-o-y) in H1. In addition, owing to the application of new regulations, the number of issued construction permits grew much faster in y-o-y terms since April, while July and August saw, on average, a 30% y-o-y increase. Furthermore, trends in government capital expenditures indicate increased implementation of infrastructure projects.

Observed on the whole, trends in service sectors were similar to those in Q2 and kept inter-sectoral divergence. Trade continued to record positive movements, as signalled by the real growth of retail trade turnover in Q3 of 2.3% s-a. Positive trends were also indicated by indicators in transport (index of physical volume of services), tourism and catering (catering turnover index and number of tourist arrivals and overnight stays) and information and communication (exports of computer and information services). On the other hand, declining tendency continued in professional, scientific, innovation and technical activities, public administration, education, health and social protection.

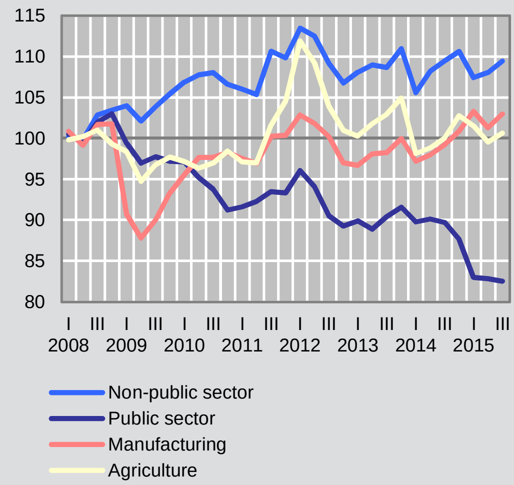
Judging by the movements in the year to date and projection for Q4, GDP should increase by 0.8% in 2015, up by 0.3 pp relative to the projection from the August *Inflation Report*. The main reasons behind the upward revision are more favourable trends in construction and a

Chart IV.5.4 **Contributions to y-o-y growth of the physical volume of industrial production**



Sources: SORS and NBS calculation.

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



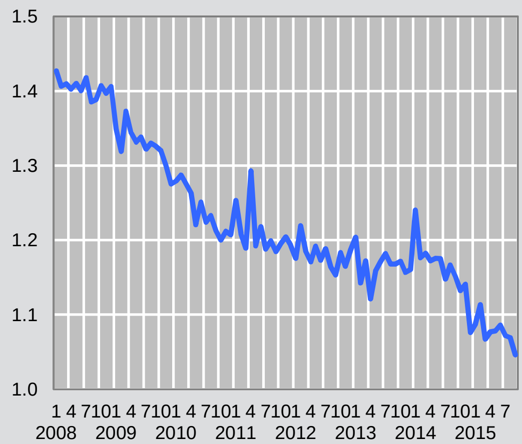
Sources: SORS and NBS calculation.

lower than expected fall in agriculture. The growth of industrial production is likely to be consistent with the expectations, with slight underperformance of motor vehicle production being counterbalanced by more favourable trends in production of base metals and chemical industry.

6. Labour market developments

Driven by the rise in the non-public sector wages, real net wages continued growing in Q3, thus slowing their y-o-y fall. In addition to the drop in productivity, it was the rise in real gross wages that led to an increase in unit labour costs in industry. Labour market indicators of the Labour Force Survey show further drop in unemployment, which was also confirmed by the National Employment Service data.

Chart IV.6.2 **Ratio of average nominal net wage in public and non-public sector**
(s-a data, H1 2008 = 100)



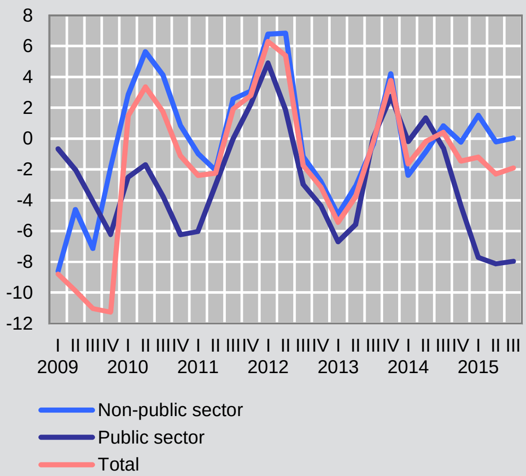
Sources: SORS and NBS calculation.

Wages and labour productivity

Real net wages in the non-public sector continued up in Q3 as well (1.3% s-a), helped by their rise in nominal terms, and additionally boosted by a drop in consumer prices. After a mild drop in Q2, real net wages in the public sector continued on a similar note in Q3, which helped narrow the gap between average wages in the public and the non-public sector further down to 4.6% in September.

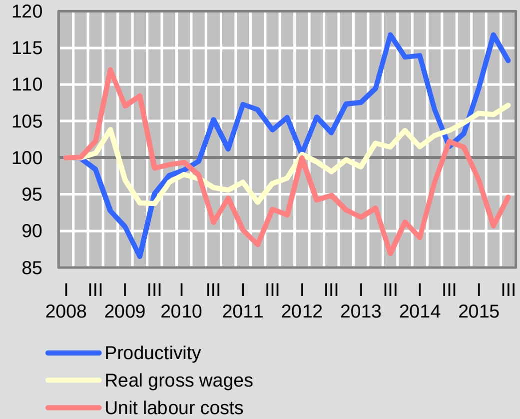
Observed by sector, real net wages climbed in all segments of industry and construction, which could be explained by the fact that activity in these sectors has been recovering since the beginning of the year. Real net wages also jutted up in transport and accommodation and

Chart IV.6.3 **Real net wage movements**
(y-o-y growth, in %)



Sources: SORS and NBS calculation.

Chart IV.6.4 **Movements in productivity, real gross wages and unit labour costs in industry**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

food services, where indicators also show rise in activity, while in the case of agriculture the increase is partly attributable to higher demand for seasonal jobs. Real net wages fell in the financial sector, professional, innovation and technical activities and in healthcare and social protection.

Overall, real net wages continued down in y-o-y terms (1.9%) in Q3. More specifically, after a slight drop in Q2, real net wages in the non-public sector flatlined in Q3. Similar to quarterly dynamics, the strongest rise was recorded in sectors with rising activity (construction, accommodation and food services, manufacturing). In y-o-y terms, wages slid further in public administration, healthcare and education – sectors dominated by public sector economic entities.

The rise in total real net wages accelerated in Q3, owing to a stronger rise in real wage bill for the non-public sector (1.2% s-a). On the other hand, public sector real wage bill continued down in Q3 (0.6% s-a), partly due to a cut in employment numbers. The rise in total real net wages affected the trends in the average nominal take-home pay in the Republic of Serbia, which equalled RSD 44.720 in Q3, staying close to its Q2 level (down by 0.5% y-o-y).

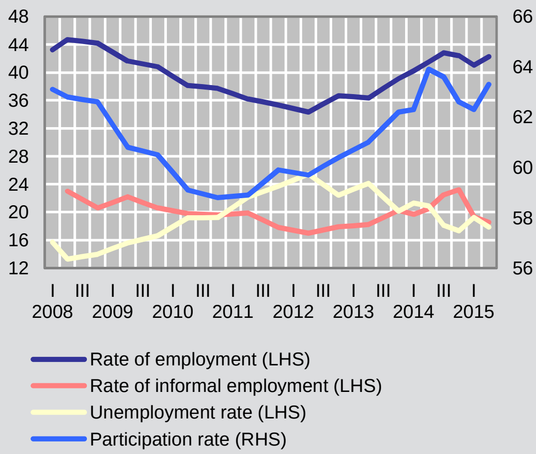
The new law on the system of wages in the public sector should be adopted by the end of the year. It is expected to ensure a transparent remuneration structure and a more efficient control of wages in the public sector. The most significant provisions in the draft law are the introduction of a single base for the computation of wages, classification of all jobs in the public sector within 60 pay grades and pay coefficients, determining the ratio of minimum and maximum wages at 1:7.5 and classification of jobs and ranks in the public sector into a single catalogue.

Unlike H1, when they dropped, **unit labour costs in industry** rose by 4.9% s-a in Q3 mainly due to lower productivity resulting from the contraction of activity in industry and the rise in employment. Gross real wages also rose in Q3. A similar increase in unit labour costs was recorded within manufacturing.

Employment

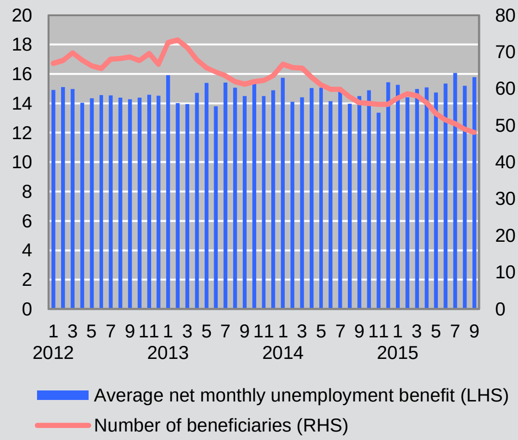
Most labour market indicators, obtained from the **Labour Force Survey** data, improved in Q2, both relative to Q1 2015 and Q2 last year. Total employment rose (1.2 pp from Q1) amid higher rate of participation (1.0 pp) and reduction in informal employment (0.9 pp). The labour force efficiency also improved, given the rise in full time employment and a decline in part-time employment in Q2. Observed by ownership structure, the number of employees rose within registered private and state-owned

Chart IV.6.5 **Labour market indicators under the Labour Force Survey**
(in %)



Source: SORS.

Chart IV.6.6 **Average monthly unemployment benefit**



Source: National Employment Service.

enterprises, while the number of workers in unregistered private enterprises declined, as confirmed by the drop in informal employment rate.

A breakdown by sector shows that in Q2 employment rose in industry, construction and the majority of service activities, but declined in agriculture and trade. While increased employment within manufacturing and construction is in correlation with higher economic activity in these sectors, the rise in employment in certain service sectors which are dominantly state-owned (education, healthcare and social protection, public administration) is contrary to trends in some macroeconomic indicators and the Decree on Public Sector Employment Ban[24]. A partial explanation of this deviation could be found in the manner of data compilation, as the figures do not relate to registered employment by sector, but are rather obtained by aggregating the sample assessment data.

According to the survey, unemployment rate fell to 17.9% in Q2, by 1.3 pp from Q1, or 3.0 pp in y-o-y terms. The sharpest drop in unemployment was recorded for the young aged 15-24 – from 47.7% in Q1 to 43.1% in Q2, or by 14,149 persons. Unfavourable trends were recorded in long-term unemployment, with the rate rising in Q2 compared to Q1, yet moving around the average recorded in 2014.

Table IV.6.1 **Employment and unemployment trends**
(in thousand, end-of-period)

	2014	2015		
	Q4	Q1	Q2	Q3
Formal employment	1,718.8	1,716.1	1,714.5	1,713.8
Farmers	441.3	434.3	410.8	410,8*
Total employment	2,160.1	2,150.4	2,125.3	2,124.6
Total unemployment	741.9	766.5	746.0	736.0
First time job seekers	256.3	259.5	252.5	249.6
Workers with previous job experience	485.6	507.0	493.5	486.3

Sources: SORS and National Employment Service.
* Latest available data under the Labour Force Survey.

According to our estimate and based on the available data from the **RAD survey**, formal employment contracted by 681 persons in Q3. Public sector employment shrank by 4,198 persons, while the non-public sector took up 3,517 new employees (compared to a quarter earlier). Observed by sector, the sharpest drop was recorded in education, administrative and auxiliary service activities and electricity, gas and steam supply, while employment expanded in manufacturing, trade and accommodation and food services.

[24] Decree on the Procedure for Acquiring Consent for New Employment and Hiring with Public Fund Beneficiaries.

National Employment Service data confirm favourable trends in unemployment, given that it contracted by 10,052 persons in Q3. Similar to a quarter earlier, the sharpest decline in unemployment was registered for the sectors of manufacturing, trade and agriculture, while an increase was recorded for the number of unemployed in public service related professions (healthcare, pharmacy and social protection, and learning and education). The number of users of unemployment benefits dipped further in Q3, coming for the first time below 50,000 persons, i.e. to 48.084 users in September.

7. International environment

Euro's depreciation, low oil prices and accommodative monetary policy continued to support economic activity in the euro area, which in turn positively affected the growth in most CEE countries. GDP growth in the USA accelerated significantly in Q2, owing primarily to private consumption boosted by labour market recovery and the rise in real disposable income.

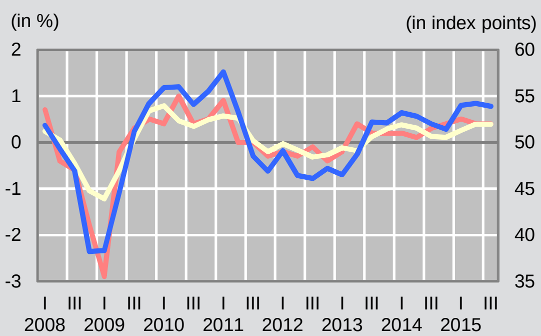
On the other hand, China's economic slowdown stemming from its gradual transition to a new economic growth model swayed monetary policy decisions of leading central banks. The Fed decided not to change its policy rate for the time being, while the ECB hinted at the possibility of more monetary stimulus in December. This should spark economic activity and help inflation return to the target – it is currently hovering around zero in both economies due to a further drop in oil prices.

Economic activity

GDP growth in the euro area continued up in Q2 (0.4% s-a), driven chiefly by exports and private consumption. The euro's depreciation vis-à-vis the dollar and the pound sterling over the course of the last year, and relatively vigorous recovery of economic activity in the USA and UK – the key export markets of the euro area – affected the rise in exports, in spite of the slower pace of growth and lower external demand from emerging markets. Favourable sway on further rise in private consumption in Q2 came from low oil prices, as well as from favourable borrowing conditions and slight improvement in the labour market – unemployment rate fell by 0.2 pp from June and came to 10.8% in September.

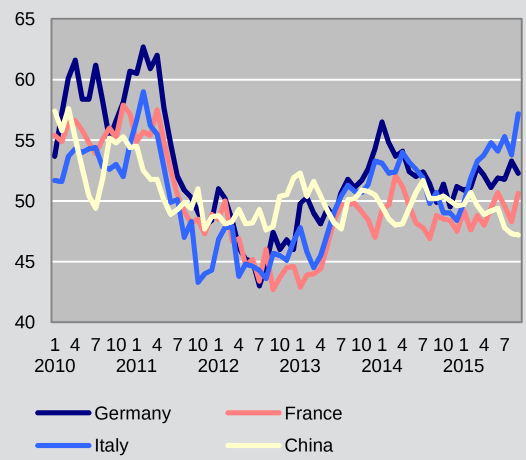
Indicating a broad-based recovery, GDP growth in Q2 was registered across all major economies of the euro area, save for France, where it flatlined. In Germany, economic growth increased 0.4% s-a, owing primarily to net exports, while the private consumption contribution was weaker than in Q1. Still, further significant

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.
* Preliminary estimate of Markit Group for Q3 2015.

Chart IV.7.2. **PMI Manufacturing for selected countries**
(index points)



Source: Markit Group.

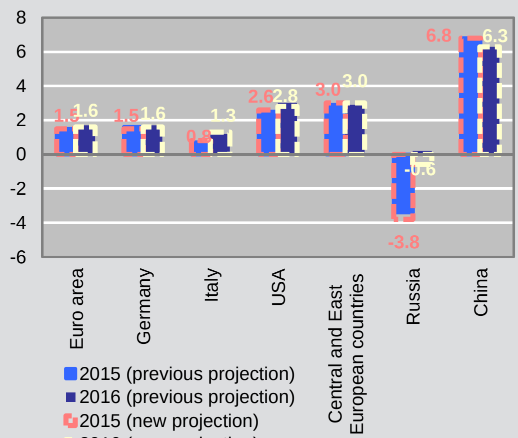
contribution of domestic demand is expected in the upcoming period, on account of low unemployment and the rise in real disposable income propelled by plummeting oil prices and low inflation. The leading indicator of production activity for Germany (PMI Manufacturing) continued to move in the expansion zone during Q3, equalling 52.3 points in September.

Based on trends of the leading indicators, GDP of the euro area is expected to continue growing in Q3 (0.4% s-a, according to the latest estimate of the Markit Group). Expected growth in 2015, according to the IMF and Consensus Forecast estimate, remained unchanged from the previous projection (1.5%), while being revised downward by 0.1 pp for 2016 – to 1.6% and 1.7%, respectively. The main reason of this revision was China's slowdown and its national currency depreciation, which could negatively affect exports of the euro area[25]. On the other hand, risks of escalation of the sovereign debt crisis in Greece have been temporarily avoided, since the agreement on a new financial assistance package was reached.

Economic activity in **Central and Eastern Europe** continued growing in Q2, owing to the euro area recovery and low oil prices. Like in the previous period, the GDP growth was strongest in Central Europe, which used the economic recovery of the euro area to the largest extent. The y-o-y GDP growth in the Czech Republic went at a faster pace than in Q1, with positive contribution coming from net exports, spurred by accommodative monetary policy and domestic demand that stemmed from higher real wages and low unemployment. On the other hand, Poland, Hungary and Romania saw some slowing in GDP growth, which however remained relatively high owing to stable domestic demand.

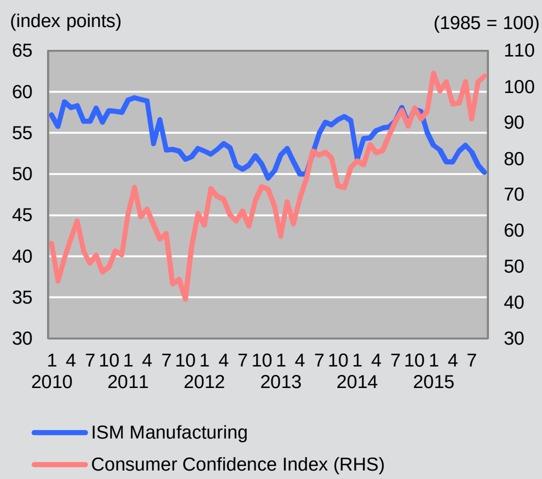
Low prices of oil and other stock exchange goods and China's growth slowdown made Russia's exports decline, pushing its y-o-y fall in GDP growth further down to 4.6% in Q2. Moreover, prolonged economic sanctions of developed countries hinder financing of the economy and contribute to higher capital outflow and lower investment, which altogether prompted the IMF to revise its growth forecast for the current and following year down to –3.8% and –0.6%, respectively. Signing of the arrangement with the IMF and partial restructuring of public debt laid the foundation for economic stabilisation in Ukraine, causing its y-o-y drop in GDP to decelerate slightly in Q2. Unexpected acceleration of the Turkish y-o-y GDP growth came as a result of stronger domestic demand. However, the lingering political uncertainty and the vicinity of armed conflicts work towards the depreciation of the Turkish currency and slight downward revision of growth outlook for the current and next year.

Chart IV.7.3 **Revisions of real GDP growth forecasts for 2015 and 2016 by the IMF**
(in %)



Sources: IMF WEO Update (July 2015) and IMF WEO (October 2015).

Chart IV.7.4 **Leading economic indicators in the US**



Source: Institute for Supply Management, Conference Board.

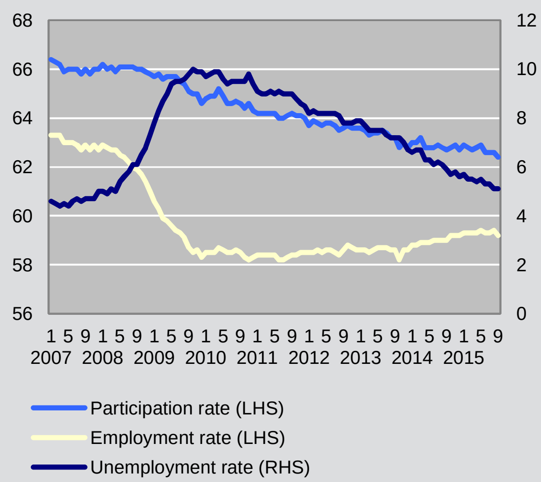
[25] See text box 2, p. 45.

On the whole, economic growth outlook in Central and Eastern Europe has, according to Consensus Forecast, been slightly revised down due to the worsened forecast for Russia. Hence, under the October projection, GDP is expected to drop by 0.1% in 2015 and rise by 1.7% in 2016. On the other hand, the latest IMF estimate indicates slight growth acceleration in the observed region[26], given the reduced direct exposure to China's slowdown.

The dampened GDP growth registered in the **USA** in Q1 (0.15% s-a) turned out to be short-lived, as it picked up rapidly in Q2 (1.0% s-a). This boost came primarily from private consumption backed by the rise in real disposable income, and to a certain extent, from consumption of local authorities, fixed investments and net exports. The rise in exports, registered despite the dollar's strengthening, can partly be put down to lower realisation in Q1 caused by unfavourable spell of weather.

Q3 witnessed the expected GDP slowdown (0.4% s-a, according to preliminary estimate), which however remains relatively vigorous compared to other developed countries. It was again private consumption that caused growth in Q3, with positive contribution coming from consumption of federal and local authorities. The rise in consumption will continue to be supported by low oil prices, higher real estate prices and low unemployment (5.1% in September). Favourable trends in the labour market were partly offset by stagnant new jobs outside agriculture in comparison to H1, and the reduction in participation rate to its all-time low in the last nearly 40 years. The composite index of production activity (ISM Manufacturing) was on a steady downward path throughout Q3 (50.2 points in September), dragged primarily by subdued activity in exports-oriented sectors of manufacturing and energy that was caused by the dollar's strengthening and China' slowdown. When compared to July data, GDP growth estimate for 2015 was revised slightly upwards (0.1 pp) – the IMF data now suggest 2.6% and Consensus Forecast 2.5% – whereas the anticipated growth in 2016 was revised down by 0.2 pp, to 2.8% and 2.6%, respectively.

Chart IV.7.5 **US labour market**
(monthly rates, in %)



Source: Bureau of Labor Statistics.

In Q3, **China's** GDP growth decelerated slightly to 6.9% in y-o-y terms, due to a more sluggish rise in industrial production and investment and the reduction in exports. The indicator of production activity – PMI Manufacturing – continued down in September, descending for the seventh consecutive month[27], while the y-o-y drop in exports also prolonged throughout Q3. Still, GDP growth surpassed market expectations, assisted by still favourable trends in the service sector which saw employment jut further up, as well as in private consumption, as indicated by the rise in retail turnover that accelerated in y-o-y terms. According to the latest estimate of the IMF and Consensus Forecast, GDP is set to rise by 6.8% in 2015, and then decline to 6.3% in 2016.

Inflation movements

During Q3, developed countries saw inflation fall, primarily due to a further drop in oil prices, with core inflation staying stable. Despite monetary policy stimulus package, after six months, the euro area again faced reduction in prices – 0.1% in y-o-y terms. Core inflation, excluding energy prices, came at 1.0%, just as in August. Given that oil prices are not expected to rise significantly in the months ahead, inflation in the **euro area** will remain rather low. Its rise at the turn of the year will come chiefly as a result of the base effect i.e. plummeting oil prices at end-2014, and thereafter, in 2016 and 2017, it is expected to rise, owing to the anticipated economic recovery, euro's weakening and recuperation in oil prices. According to the results of the quarterly Survey of Professional Forecasters, published by the ECB in October, short-term inflation expectations have dipped despite the QE programme (primarily due to low oil

[26] Excluding Russia, Ukraine and other members of the euro area.

[27] Below 50 points.

prices), while mid-term and long-term inflation expectations remained intact.

The fall in inflation throughout Q3 in **Central and Eastern European** countries was led by lower prices of oil, but also of food, which carries a significant weight in the index of consumer prices in these countries. Negative inflation rates were most pronounced in Romania and Bosnia and Herzegovina, but also in Bulgaria, which has been facing deflation for two years now. Disinflationary pressures also spread across Croatia, Hungary and Macedonia, though to a lesser extent, with the exception of Russia and Turkey, which have faced significant currency depreciation and consequently high inflation rate.

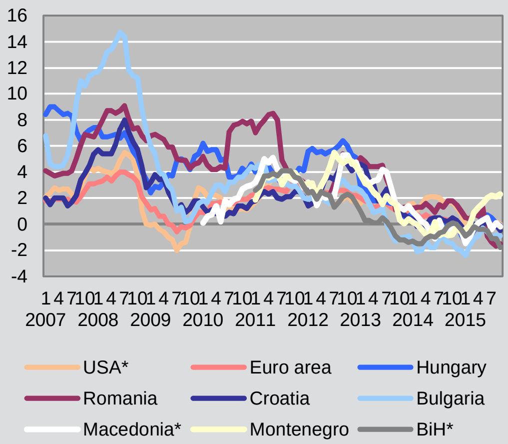
Lower energy prices and stronger dollar, which put a drag on imports, prevented inflation from rising in the **USA**. Even though it reached its peak figures for 2015 in July and August (0.2% y-o-y, propelled by a rise in shelter prices), y-o-y inflation dropped to zero in September. This is attributable to an 18.4% decline in energy prices (primarily a 29.6% drop in gasoline prices), which neutralised the rise in other prices. Core inflation (excluding energy and food prices) inched to 1.9% in September, surmounting the steepest path since July 2014. Fed expects inflation to gradually rise in the upcoming period as oil prices pick up from the unusually low level.

Monetary policy

Despite visible signs of recovery, it would seem that numerous conventional and unconventional measures of the ECB monetary policy, implemented as of June 2014, have fallen short of expectations. Ending with September, the ECB purchased a total of EUR 341.5 bln of government bonds, making total bonds purchased under the expanded asset purchase programme amass to EUR 475.6 bln. Although corporate and household borrowing conditions have been improved, credit growth remains modest. Disinflationary pressures are still present in the majority of the euro area countries, and where deflation is absent, rather low inflation has taken up its place. Signs of China's slowdown and growth outlook of the emerging countries, along with possible consequences for the financial and primary commodities markets, pose a great risk for economic growth and inflation in the euro area. Following the Fed’s September decision to postpone the expected increase in the policy rate, it was agreed on that more must be done to help the euro area economy recuperate and bring inflation back on target.

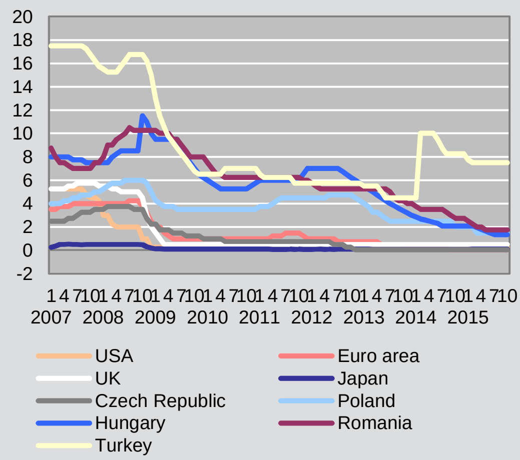
After its October meeting, the ECB stated that it was re-examining the degree of monetary accommodation, but that it would make decision on possible additional stimulus in December, when new macroeconomic projections are available. The ECB did not specify whether it would expand its asset purchase programme

Chart IV.7.6 **HICP across selected countries**
(y-o-y rates, in %)



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

Chart IV.7.7 **Policy rates across selected countries**
(annual level, in %)



Sources: Central banks of selected countries.

and/or additionally trim the deposit rate. The fact that the ECB is discussing the possibility to trim its deposit rate took the market by surprise and incited further decline in yields on government bonds of the euro area countries, pushing up the value of government securities with negative yields (around 25% of the market). Even two-year Spanish and Italian bonds entered the negative zone. The sharpest fall in yields (i.e. rise in prices) in Q3 was recorded for Greek government bonds. During the review period, credit rating agencies Standard & Poor's and Fitch lifted Greece's rating by two and three levels – from CCC- to CCC+, and from CC to CCC, respectively. Standard & Poor's and Moody's improved Greece's outlook from negative to stable.

Central banks in **Central and Eastern Europe** have mostly ended their monetary policy easing. During Q3, it was solely the Central Bank of Hungary that cut its key policy rate, trimming it by 15 bp to 1.35%. To support further easing of recession, the Central Bank of Russia also cut its rate once in the course of Q3 – by 50 bp to 11%. This is quite weaker easing intensity compared to Q2 when the Russian central bank slashed its key rate by 250 bp.

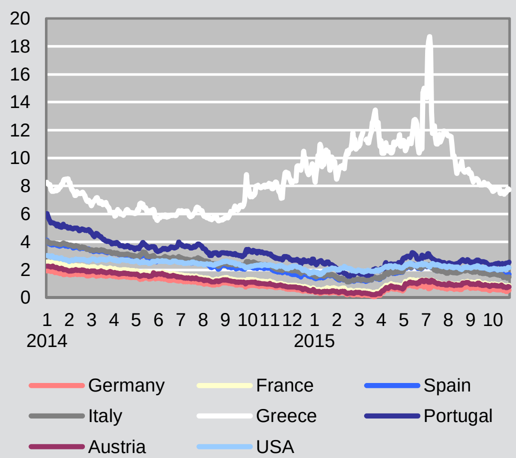
The **Fed** postponed its decision to raise the policy rate in September as well. The main reason behind this is the concern that the slowdown in China, being the second largest world economy, could put a drag on global growth, including the American economy, which would push the already low inflation further down. However, thirteen out of seventeen participants of the Federal Open Market Committee said they expected the policy rate to be increased by at least 25 bp till end-2015. Among them is the Fed Chair, which warns that keeping short-term interest rates near zero, once economic activity is normalised, could encourage excessive risk taking and threaten the financial stability. Still, weaker than expected labour market results over the last two months, global economic slowdown, low oil prices and quite low inflation which trudges far from its target, hint that the Fed could postpone its decision for March 2016.

Financial and commodity markets

China's slowdown, the fact that the Fed did not raise its policy rate in September and uncertainty whether it will do so until end-2015, and the announced possible additional monetary stimulus of the ECB, reflected on the trends in the international financial and commodity markets.

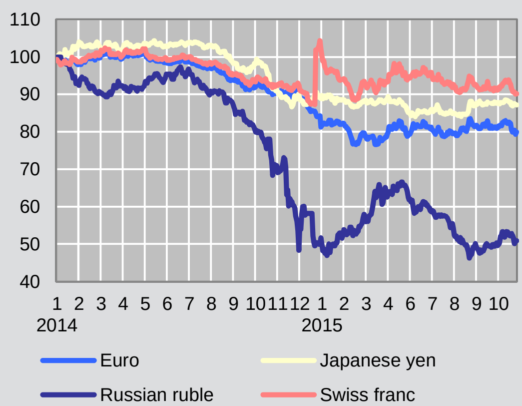
The euro depreciated in July because of the Greek crisis, pushing up against the dollar again thereafter.

Chart IV.7.8 **Yield on 10-year bonds of selected countries**
(daily data, in %)



Source: Bloomberg.

Chart IV.7.9 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



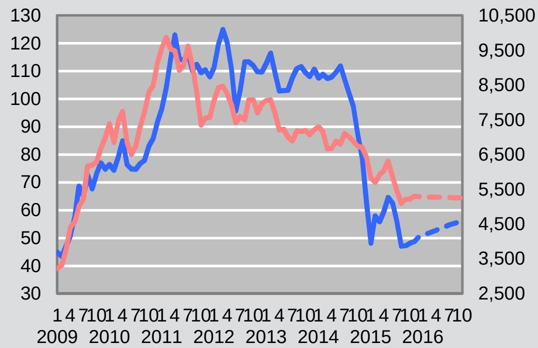
Source: IMF database.
* Growth indicates appreciation.

Expectations regarding the Fed's September decision were the prime factors determining the **dollar's** trends, first upwards, and later, as the rise in the policy rate was postponed, downwards. Consequently, at end-Q3, the exchange rate of the dollar vis-à-vis the euro remained unchanged from end-Q2.

Signals of China's economic slowdown and the sudden devaluation of the Chinese national currency led to "Black Monday" on 24 August that swept through Chinese and world stock exchanges. The high tide of uncertainty in the international financial market is best witnessed by the leap that the CBOE Volatility Index – VIX took that day, rising from 28.0 (a day earlier) to 40.7 – its highest level since 2011. However, stimulus of the Chinese central bank and expectations of a less likely September rise in the Fed's policy rate helped market stabilise relatively quickly.

After rising by 15% in Q2, global oil prices plunged by 23.2% in Q3. At end-October, oil prices equalled USD 47.6 per barrel. This drop came as a consequence of dampened global economic activity, but it was the higher than-anticipated supply from both the OPEC countries and the USA and Russia that acted as the decisive factor. Also, the supply was expected to rise further because of Iran's return to the market after signing the nuclear agreement. Although lower oil prices encourage oil demand, other factors limited the rise in broad-based production, which would have sparked oil market rebalancing. All in all, it will take the oil market more time to adjust to the excess supply and so oil prices are

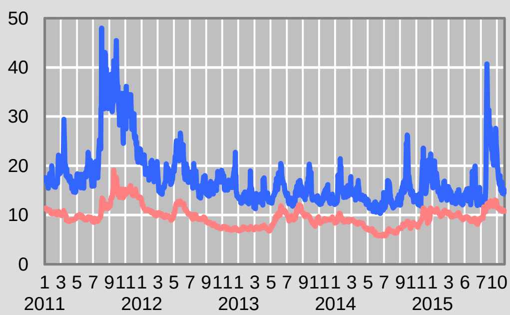
Chart IV.7.11 **Oil and copper price movements**
(average monthly prices, in USD)



Price of Brent oil per barrel (LHS)
Brent oil futures (LHS)
Price of copper per ton (RHS)
Copper futures (RHS)

Source: Bloomberg.

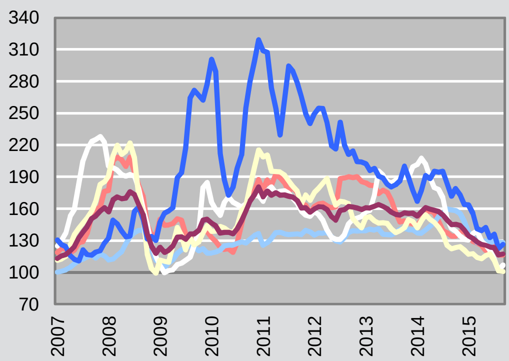
Chart IV.7.10 **Implied volatility of the global financial market***
(in %)



VIX EM-VXY

Source: Bloomberg.
* VIX (Chicago Board Options Exchange Market Volatility Index) measures implied volatility of the S&P 500 index; EM-VXY (JPMorgan emerging markets implied volatility index) measures aggregate volatility of emerging market currencies based on three-month forward options.

Chart IV.7.12 **World food price index**
(in real terms, 2002−2004 = 100)



Cereals
Meat
Dairy products
Oils and fats
Sugar
FAO index

Source: FAO, UN.

expected to remain at the low level in the upcoming period (International Energy Agency predicts they will stay low throughout 2016). Apart from oil, prices of other primary commodities, especially **base metals**, have also declined. China's economic activity has an even greater role in the metal market than in the oil market. China' share in global consumption of these metals has soared over the last fifteen years, rising from 10% to over 50%. As demand for metal is expected to remain subdued, their prices are not likely to recuperate in the near future.

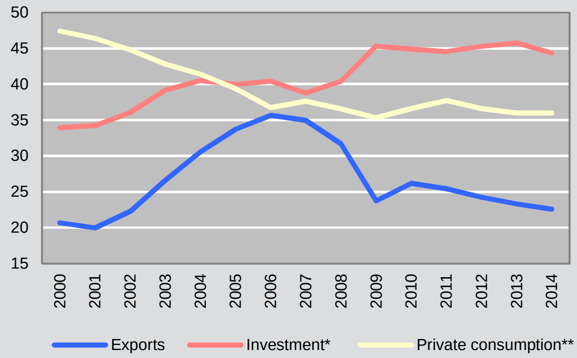
In Q3, **world food prices**, measured by FAO index, continued the downward journey they started in April 2014. They dropped in real terms by 5.2% from Q2 and by 19.1% from the same period last year. Q3 saw prices of all food categories drop, save for meat prices, which have been relatively stable since March this year, but lower in real terms by 19.4% relative to September 2014. The sharpest decline in Q3 was posted by edible oil prices (14.0%), which hit their lowest level since March 2009. As in the previous quarter, prices of dairy products fell sharply (11.4%), primarily in July and August (due to the abolition of the EU milk quota, large inventories of dairy products in New Zealand, uncertainty over the rate of China's imports and the on-going sanctions on Russian imports), but recovered in September (5.0% rise from August) – yet however, dropping by 24.5% from September 2014.

In Q3, the prices of cereals dropped by 5.1% in real terms (13.4% from September last year). Since the beginning of the year, world cereal prices have been pressed down due to large inventories and generally positive outlook for the harvest. After record production this year, wheat is now over 20% cheaper than in September last year. Owing to the expected lower production, corn prices were resilient and were supressed by only 1.4% from September 2014.

Text box 2: Implications of movements in Chinese economy on global trends and Serbia

Following a sharp drop in stock prices and the change in the exchange rate policy, China was the epicentre of global economic developments this summer. Such developments stemmed partly from the rebalancing and gradual liberalisation of the Chinese economy. To be exact, in the years up to the crisis, China' economic growth rested on exports, whose share in GDP, during the 2000–2007 period, leaped from 20% to 35%. Once the crisis broke out, demand for goods manufactured in China subdued, slowing down the rise in exports and pushing their share in GDP to 22% in 2014. As the drop in exports was not offset by the rise in private consumption, Chinese authorities encouraged investments in order to maintain the strong dynamics of economic growth, averaging 10.5% in 2000–2007. The share of investment in GDP rose from 38% in 2007 to 45% in 2014. The rise in investment, chiefly funded by borrowing, led to higher indebtedness, which rose fastest in the sector of enterprises. Consequently, any slowdown of economic growth threatened debt repayment and created risks for the sustainability of the financial system.

Chart O.2.1 **Share of major macroeconomic aggregates in GDP**
(in % of GDP)



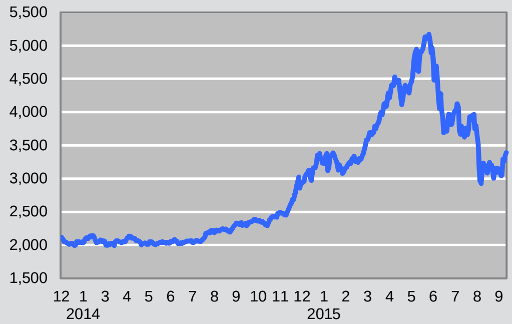
Sources: World Bank and NBS calculation.
* NBS calculation for 2014.
** Latest available data for 2013.

To ensure long-term sustainable economic growth, Chinese authorities opted for a gradual transition to a new economic growth model, which, instead of resting on exports and investments, is based on encouraging private consumption and developing the service sector, which in the short run could stall growth of the economy. The new model was also supported by the Chinese central bank, which began easing its monetary policy in late 2014. Thus began the cycle of interest rate trimming from 6.0% in November 2014 to 4.35% in October 2015, while the reserve requirement ratio was reduced from 20.0% to 17.5% since the beginning of 2015 until October.

Higher yields on investment in stocks than in real estate, and the already initiated liberalisation of the financial market positively affected the trends in the Shanghai Stock Exchange, whose index surged in mid-June 2015 by around 150% in y-o-y terms. However, trends in the financial market were not supported by developments in the real sector, whose growth slowed down during H1 2015, as indicated by movements of the leading indicator of production activity – PMI Manufacturing index, moving below 50 points almost incessantly since December 2014. Responding to this disproportion, in mid-June, investors started reducing their exposure to stocks of Chinese companies. This exerted a domino effect on the stock exchange and pulled the index deep down, so since the beginning of July, the Shanghai Stock Exchange index lost around 30% of its value. Regulatory bodies tried to cushion this decline by limiting short-selling and new initial public offering (IPO), and by prohibiting stockholders with the share of over 5% in a company's capital to engage in sale.

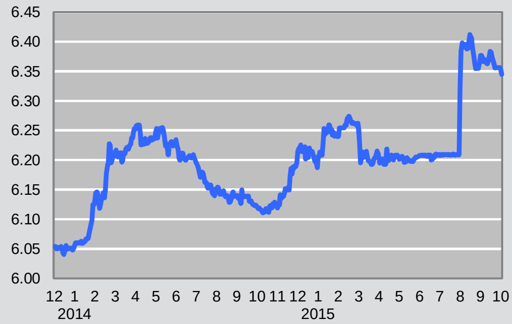
These measures helped stabilise trends in the stock exchange, yet in mid-August, a new shock shattered China's financial market, created by the central bank's decision to shift to a more market-determined exchange rate. Such a decision was made primarily with a view to fulfilling the IMF standard for the inclusion of the Chinese currency into the basket of currencies that form the SDR. However, markets responded to this decision perceiving it as evidence of further slowdown of China's economy and boost to exports – on 11 August, China's currency lost 1.9% vis-à-vis the dollar, which is the sharpest daily depreciation since 1994, only to depreciate by an additional 1.6% the very next day. Later, once the data on production activity in August (Flash China General Manufacturing PMI[1]) were published, there ensued a new, strong decline in stock prices on the stock exchange on 24 and 25 August (8.5% and 7.6%, respectively), pulling back the stock index to its early-2015 level.

Chart O.2.2. **Shanghai Composite Stock Exchange Index**
(in index points)



Source: Yahoo Finance.

Chart O.2.3. **USD/CNY exchange rate**



Source: FRED.

Turbulences in the Chinese financial market affected global trends as well. The worldwide interconnectedness of stock markets made the drop in stock prices in China reflect on the decline in stock prices on other major world stock exchanges. Besides, higher risk perception impacted on capital outflow and depreciation pressures in some emerging economies, chiefly affecting countries that have developed trade relations with China (Malaysia, Indonesia and Thailand). Plummeting prices were recorded in most commodity markets, primarily industrial raw materials (copper, steel and aluminium), whose global-scale trade is dominated by China.

The effect on real economy could come from China's economic rebalancing and its expected slowdown, which would result in lower global demand and slowdown across countries with important trade relations with China. It should be noted that lower demand from China could reflect on oil and other primary products prices, causing them to drop or stagnate at a low level. This would prolong disinflationary pressures in countries facing low inflation and could partly affect their monetary policy decisions, which would in turn reflect on global financial flows.

As regards the impact of developments in China on our economy, it should be noted that Serbia's direct exposure to Chinese economy is not large, given the relatively low share of our exports to China (0.1% in 2014) and minor residents' investment in its financial market. Serbia's economy is primarily exposed to the slowdown of the euro area, our most important trade partner, yet this effect is softened given the indirect nature of the exposure. On the other hand, as Serbia is a net importer of oil, low oil prices should have a positive effect on our terms of trade, production costs and disposable income.

[1] http://www.markiteconomics.com/Survey/PressRelease.mvc/b2215b5e205042329c5aa7ee1aa5abee.

V. Inflation projection

Under our central projection, y-o-y inflation will be hovering around the lower bound of the target tolerance band until mid-2016. In H2 2016 it is expected to trend steadily closer to the 4.0% target. While inflation growth in the short term will be due to the low last year's base for petroleum product and cigarette prices, in the medium term it will reflect the weakening of disinflationary pressures amid a gradual rise in aggregate demand and inflation in the international environment. The risks to the projected inflation path are associated with international primary commodity prices, the adjustment of electricity prices next year and economic developments abroad, notably the fallout from China's slackening growth.

GDP is projected to grow by 0.8% in 2015 and by 1.8% in 2016. Its growth rates have been revised up by 0.3 pp relative to the previous projection as the rise in investment is faster than expected.

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 (4.0±1.5%) in Q3 and amounted to 1.4% in September. Inflationary pressures remained subdued, as a result of the majority of domestic factors, as well as low inflation abroad and low prices of primary commodities in the international market. Core inflation (CPI excluding food, energy, alcohol and cigarettes), which has been running below the target tolerance band since August 2014, reached 2.1% y-o-y at end-September.

Q-o-q, consumer prices inched down by 0.1% in Q3. The largest positive contribution stemmed from administered prices, i.e. electricity and cigarette prices (0.7 pp in total), while prices of unprocessed food, notably vegetables, worked in the opposite direction (-1.0 pp).

Extended period of low inflation and anticipation of weak inflationary pressures in the period ahead have contributed to further lowering of inflation expectations. One-year ahead inflation expectations of the financial sector and businesses are at the lowest level on record. Two-year ahead inflation expectations of both sectors are also within the target band.

The exchange rate of the dinar against the euro remained stable in Q3. By the end of the quarter, however, appreciation pressures gathered pace. These developments can be put down primarily to the country's improved macroeconomic and fiscal performance, confirmed also by the completion of the second review of the stand-by arrangement with the IMF. Several factors worked towards boosting the supply of foreign exchange – increased FDI inflow, relatively high inflow of remittances and continued rise in banks' FX-indexed assets, while factors underpinning weaker demand for foreign exchange included considerably smaller purchase of foreign exchange by non-residents and a much smaller volume of net foreign debt repayment by banks relative to Q2. On the other hand, banks sold a larger amount of foreign exchange to enterprises than in Q2. In order to ease excessive short-term appreciation of the exchange rate, the NBS intervened in the IFEM from July to October by buying foreign exchange in the total amount of EUR 520.0 mln. The NBS intervened on the sale side on two occasions (August and October), selling each time EUR 10.0 mln.

Based on the Monetary Conditions Index, the monetary policy stance has been expansionary for more than a year now, which is consistent with the current undershooting of the inflation target tolerance band. The expansiveness of monetary conditions in Q3 is suggested both by the sustained depreciation gap of the real exchange rate (dinar's depreciation against the euro in the past year exceeded the inflation differential between Serbia and the euro area) and the real interest rate[28] (the reduction of the key policy rate dragged the real interest rate below the neutral level, pushing it even into the negative territory in October).

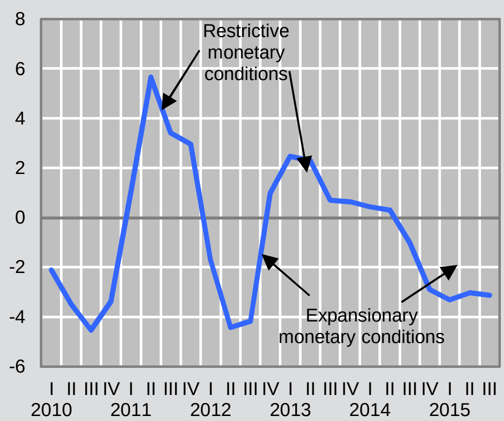
After completion of the second review of the arrangement with the IMF, which focused on public finances as at end-Q2, favourable fiscal developments continued into Q3. Consolidated budget deficit amounted to 1.8% of GDP in the first nine months of 2015 and was significantly lower than the ceiling envisaged by the agreement with the IMF (RSD 51.1 bln vs. RSD 153.1 bln). At the same time, primary surplus of 1.9% of GDP was posted. Though deficit is expected to be higher in Q4 than in Q3, according to our estimates, the share of consolidated budget deficit in GDP in 2015 will be around 4.0% or some 2.5 pp lower than in the previous year.

Based on NBS estimate, GDP contracted by 0.4% s-a in Q3, rising in y-o-y terms, however, by 2.0%.On the production side, GDP received headwinds from industrial production and services, and impetus from construction industry. The fall in industrial production was led primarily by manufacturing and to a lesser extent by slackened activity in the energy and mining sectors, which exceeded pre-flooding levels in Q2, but then recorded a moderate decline in Q3.

The economic contraction in Q3 has widened the negative output gap slightly further, which heralds continuing disinflationary pressures from aggregate demand in the medium run.

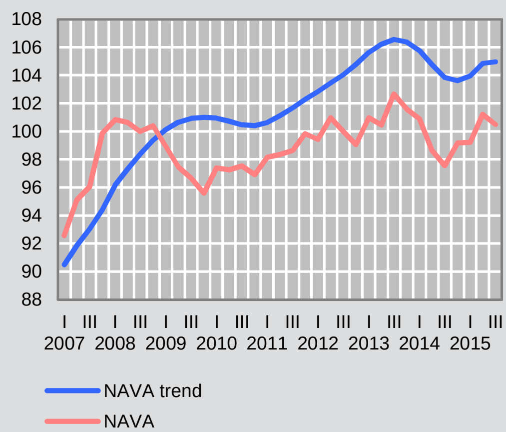
After 0.4% s-a growth in Q2, economic activity indicators suggest that the euro area's GDP continued growing at a similar pace in Q3. Though the recovery of the euro area is supported by the accommodative monetary policy stance of the ECB, the weakening of the euro and lower oil prices, significant risks to the region's economic growth and inflation are coming from the slowing growth of emerging markets, notably China. In light of this, the ECB announced it would re-examine the degree of monetary policy accommodation at its

Chart V.0.1 **Monetary conditions index**
(in %)



Source: NBS.

Chart V.0.2 **Output gap**
(Q3 2008 = 100)



Sources: SORS and NBS calculation.

[28] Real interest rate is derived as the difference between one-week BELIBOR and one-year ahead inflation expectations of the financial sector measured by Bloomberg.

December meeting. At the same time, the Fed does not exclude the possibility of rate hikes until the end of the year despite potential negative effect of China's slowdown on the US economy.

Inflation projection assumptions

External assumptions

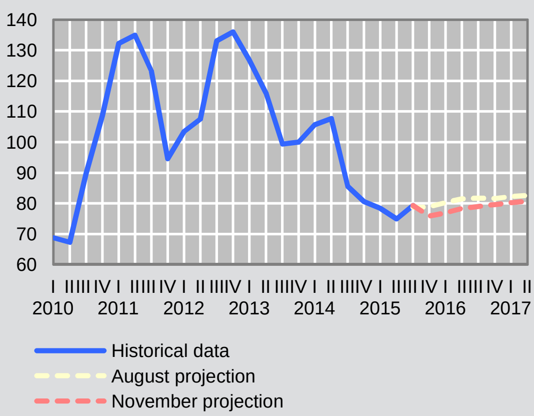
The assumption for the euro area's GDP growth in 2015 has remained unchanged from the August projection at 1.5%, while that for the next year has been trimmed down slightly to 1.7%.[29] To achieve these growth rates, domestic demand in the euro area should be supported by monetary policy measures, and the consequent improvement in financial conditions, progress in the implementation of fiscal consolidation and structural reforms, as well as by lower oil prices which will have a positive effect on real disposable income of households and the lowering of costs for businesses. On the other hand, the main downside risk to these projections is reflected in increasingly uncertain outlook for emerging markets' growth, which could weigh down on the demand for euro area exports. In addition, the euro area is faced with the tepid pace of structural reforms and the need for balance sheet adjustment across a number of sectors, which could slow down its recovery in the medium term.

After rather low, but still positive rates recorded in the period May–August, y-o-y inflation fell back into the negative territory in September (-0.1%). Though inflation should stay low in the coming period as well, we expect it to rise by the end of the year due to the base effect, i.e. lower inflation last year as a result of the oil price collapse. Owing to the unconventional measures of the ECB and the weakening of the euro vis-à-vis other world currencies (because of the divergent character of the monetary policies pursued by the ECB and most other central banks), inflation rise is likely to continue in 2016. Consistent with the announcements of ECB officials, the markets expect no change in the ECB's main refinancing rate over the coming twelve months (Consensus Forecast).

After a huge leap in the second half of June, international prices of primary agricultural commodities (corn, wheat and soybean)[30] tumbled down in July and August. Over the last two months they regained some ground, but stayed relatively low, sustaining low food production costs. Consistent with commodity futures, we have revised our assumption for commodity prices slightly down relative to the August projection. Though they are likely to grow from the beginning of 2016, this growth is expected to be rather moderate.

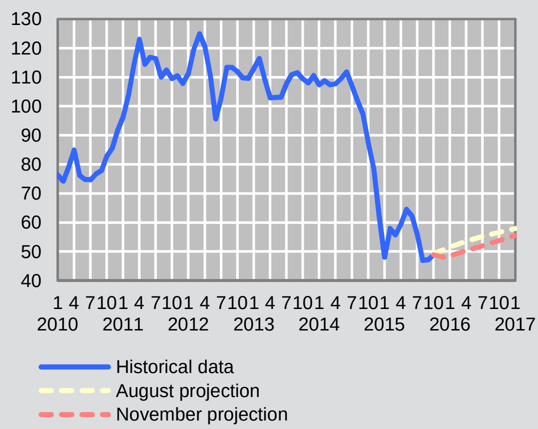
After plummeting in the first half of Q3 and hitting in late August their lowest level since March 2009 (USD 43 per

Chart V.0.3 **Assumption for international prices of primary agricultural commodities**
(Q4 2013 = 100)



Sources: BSE, CBOT and NBS.

Chart V.0.4 **Assumption for Brent oil prices**
(USD/barrel)



Sources: Bloomberg and NBS.

[29] The assumption for the euro area's GDP growth in 2015 and 2016 is consistent with the October Consensus Forecast.

[30] Measured by the composite index which comprises dollar prices of wheat, corn and soybean in the benchmark commodity markets.

barrel) amid investors' concerns over global economic prospects, oil prices[31] marked some gains and settled at around USD 49 per barrel at end-October. Taking into account the movement in oil futures, we have revised our assumption for oil prices slightly down relative to the August projection. We expect oil prices to stay in the region of USD 50 per barrel this year and to rise modestly in 2016.

Internal assumptions

Based on their trend so far and the fact this year's agricultural season was slightly below average, we assume domestic prices of primary agricultural commodities will rise moderately both this and the next year.

Having been extremely weak in 2014, administered price growth should be slightly higher this year (around 4.0%), albeit considerably lower than its average in the previous several years. The key drivers of this growth will be the prices of electricity (upward revision in August) and cigarettes (low last year's base). In 2016, administered prices are expected to grow at a similar rate (around 5%), led primarily by the assumed 7% increase in electricity prices.

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

	2015		2016	
External assumptions				
EU inflation (Q4 to Q4)	0.8%	(-)	13%	(-)
ECB policy rate (year-end)	0.05%	(-)	0.05%	(-)
Euro area GDP growth	15%	(-)	17%	(-0,1)
International prices of primary agricult. commodities (Q4 to Q4)*	-6.0%	(-4.0)	6.0%	(+2.0)
Brent oil price per barrel (year-end, USD)	48.0	(-3.0)	55.0	(-3.0)
Internal assumptions				
Administered prices (Dec to Dec)	4.0%	(-0.8)	4.9%	(-0.1)
Trends				
Appreciation trend of the real exchange rate (average)	12%	(-0.1)	13%	(-)
Real interest rate trend (average)	2.8%	(-)	2.5%	(-0.2)

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

We have also assumed, consistent with the announcements from the Government, continued fiscal consolidation in the coming period that will ensure public finance sustainability and put public debt on a downward path from 2017 onward. In line with this, the country risk premium should also be stable.

The projection also operates on the assumption of an appreciation trend of the real exchange rate, which is typical for transition economies and conditioned by the removal of price disparities, notably in terms of administered prices, and by the Balassa-Samuelson effect[32].

Projection

Inflation projection

Y-o-y inflation will stay low until mid-2016, hovering around the lower bound of the target tolerance band. In H2 2016 it is expected to steadily trend closer to the 4.0% target. Decisive impact on inflation movements over the coming twelve months will be exerted by the low base for cigarette and petroleum product prices. In the medium term, disinflationary pressures are likely to grow weaker in response to the gradual increase in aggregate demand and inflation in the international environment.

Short-term inflation projection

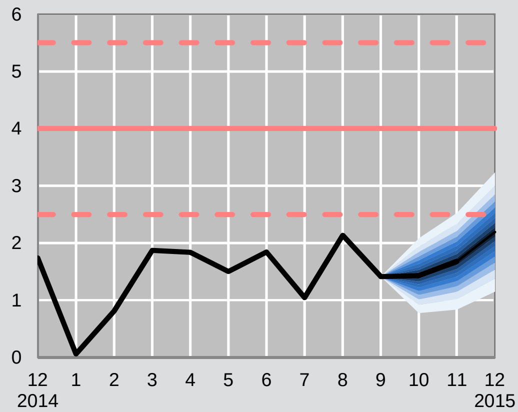
Under the short-term inflation projection, y-o-y inflation will be on a gradual rise in Q4 2015, but will continue to move below the lower bound of the target tolerance band.

At quarterly level, consumer price growth in Q4 will be led by the prices of non-food products and services, above all by the increase in prices of travel packages and the seasonal rise in prices of clothes and footwear. On the other hand, a dampening effect on inflation in Q4 will come from unprocessed food prices, due to the seasonally-induced cheapening of meat, and from energy prices, due to the expected cheapening of petroleum products and gas.

[31] Brent.

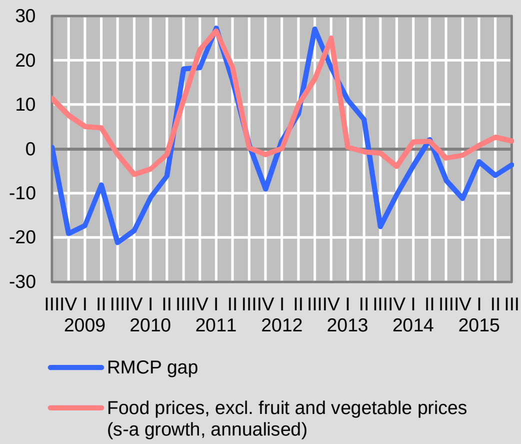
[32] In transition economies, the convergence of income levels towards the levels recorded in advanced economies is accompanied by the relatively faster growth in prices (price convergence).

Chart V.0.5 **Short-term inflation projection**
(y-o-y rates, in %)



Source: NBS.

Chart V.0.6. **Impact of RMCP on food prices**
(in %)



Source: NBS.

Core inflation (CPI excluding food, energy, alcohol and cigarettes), which has been undershooting the target tolerance band since August last year, will continue to move below the lower bound of the target band in the remainder of the year. At quarterly level, core inflation will be higher than in Q3 and will be driven by the anticipated rise in prices of travel packages, clothes and footwear.

Medium-term inflation projection

Inflation is expected to temporarily return within the target tolerance band in January and to stabilise within the target band on a more durable basis from mid-2016 onward. Inflation's return within the target band in January will reflect low last year's base for prices of cigarettes and petroleum products. Namely, these prices recorded a sharp fall in late 2014 and early 2015, and on this account alone y-o-y inflation should rise by around 1.0 pp until January.

Looking over the projection horizon, y-o-y inflation growth will also be aided by the assumed increase in prices of primary commodities (oil and primary agricultural commodities), and from H2 2016 also by the increase in prices of non-food products and services. On the other hand, aggregate demand and low inflation in the international environment will continue to act as disinflationary factors, though increasingly less so because of the expected recovery of economic activity in Serbia and the gradual rise in euro area inflation.

Negative y-o-y growth rates recorded by administered and petroleum product prices in the major part of 2015 should reverse in the coming period. In case of petroleum product prices, positive growth rate will be attributable to the drop-out of their reduction a year ago from inflation calculation, assuming however gradual recovery of global oil prices.

Within administered prices, the largest contribution to inflation next year is expected from the prices of electricity (the assumed increase in 2016) and cigarettes (statutory excise tax adjustment). And yet, over the entire projection horizon y-o-y administered price growth is likely to stay below 5.0%, which is significantly lower than the average in the several previous years.

Though food inflation was low in the last two years due to low food production input costs (negative RMCP gap[33]), these costs are now somewhat higher than a year ago. Taking this into account, as well as the assumed moderate rise in primary agricultural commodity prices over the projection horizon, food inflation can be reasonably expected to record a moderate increase, but not to exceed the inflation target (4.0%). After falling sharply in Q3 this year, fruit and vegetable prices approached their neutral level (i.e. long-term trend level)

[33] Real marginal costs of processed food producers (RMCP) are calculated as the ratio of primary agricultural commodity prices and food prices. When these costs fall below the trend level, negative RMCP gap opens.

and their y-o-y growth over the projection horizon is not likely to go over 4.0% either.

Owing to relative stability of the exchange rate of the dinar against the euro over the past several months and low inflationary pressures in the international environment, y-o-y growth in prices of non-food products and services has been weak for quite some time already (around 2.5% y-o-y) and should stay that way until mid-2016. Though this growth is likely to step up in H2 2016 due to the opened depreciation gap of the real exchange rate, until the end of the projection horizon it should not be higher than 4.0%.

Domestic demand continues to be the main disinflationary factor in the medium term. Still, the negative output gap could start narrowing down in the coming period amid accommodative monetary policy stance of the ECB, hitherto monetary easing by the NBS and the expected recovery of the domestic economic activity. As in the previous projection, we maintain that this is the last year in which household consumption will be weighed down by fiscal consolidation, i.e. that it will gradually heal from 2016 onward.

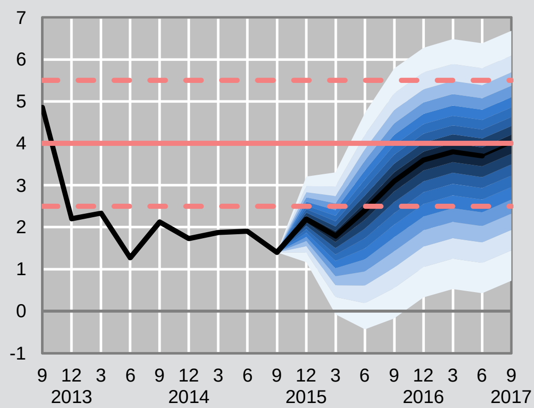
The risks to the projected inflation path relate primarily to the movements in international primary commodity prices (oil and primary agricultural products) and the adjustment of electricity prices next year, as well as to economic developments in the international environment.

Based on available information, we have assumed that over the forecast period the prices of primary commodities will record a mild rise from their currently low levels. However, as primary commodity prices are generally rather volatile, the likelihood that they will deviate from the assumed path is not at all negligible. The resumed fall in oil prices over the past several months is driven by the oversupply which shows no sign of abating and by the weaker global demand. Though oil prices are at their six-year nadir now, wherefore bottoming out seems more likely than making new lows, the faltering growth of China and, possibly, of the global economy could delay their rebound. This means that even though we have assumed a mild recovery in oil prices over the projection horizon, it is not at all impossible that this recovery will not take place. Over the past two years high inventories of cereals (corn, wheat and soybean) have been built up, which, coupled with the current low oil prices, could lead to a sharper drop in cereal prices in the near term. Namely, lower oil prices put downward pressure on cereal prices, since they lower the costs of fertiliser production and transport and discourage production of biofuels from cereals. This taken into account, the risks to the projected path of primary agricultural commodity prices are judged to be tilted to the downside.

At this point we do not know whether electricity prices will be increased next year and to what extent. Still, being cautious and aware of the need for the convergence of electricity prices to market levels, we have assumed that they will increase next year by 7%. If this assumption does not materialise, inflation will be lower than projected by around 0.3 pp. This means that the risks to the assumed path for electricity prices are also tilted to the downside.

The key features of the international environment at this point are divergent monetary policies of leading central

Chart V.0.7 **Inflation projection**
(y-o-y, in %)



Source: NBS.

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%. Each following shade includes 10% probability, which means that outturns of inflation somewhere within the entire fan chart are expected 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%.

banks and concerns over China's slackening growth. For years China recorded very high, and often two-digit, growth rates, but has lost momentum over the past several years. China's GDP growth rate is expected to be below 7% this year and to stay close to that level in the years ahead, consistent with the Chinese government's commitment to rebalance from an export and investment driven economy to a higher consumption share of GDP. While slowing growth was an expected development because of China's rebalancing act, the cross-border impact might prove stronger than anticipated, possibly affecting global economic growth. If this slows the euro area recovery, through dampened demand for its exports, Serbia would see a wider negative output gap and stronger disinflationary pressures from aggregate demand. It can be concluded that the risks around the inflation projection in this segment are also skewed toward the downside.

Upside risks to the inflation projection are currently less pronounced and relate to the expected hike of the Fed's rate, which might strain further terms of external financing for emerging market economies. Also, as of this summer, i.e depreciation of the Chinese currency, the international financial market has seen increased volatility and investors' risk aversion. Though Serbia was not among them, many emerging market economies were exposed to depreciation pressures and equity prices were adjusted sharply worldwide. Continuation of these movements could dampen capital inflows to emerging markets, Serbia included, and trigger depreciation, putting ultimately upward pressure on domestic prices.

On balance, the risks to inflation projection are judged to be mildly tilted to the downside.

As inflationary pressures are likely to stay low in the period ahead, the monetary policy stance of the NBS should remain expansionary. Given the current prevalence of external risks associated with movements in the international financial and commodity markets, the degree of monetary expansion will depend primarily on the assessment of the potential inflationary effect of these risks.

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

	2015		2016	
	Previous	New	Previous	New
Inflation (annual average, in %)				
IMF	16	-	3.4	-
European Commission	2.4	16	4.1	3.3
Consensus Forecast	2.3	18	3.9	3.5
GDP (%)				
IMF	0.5	0.75	15	175
European Commission	-0.1	0.7	12	14
Consensus Forecast	-0.2	0.4	17	16
Current account deficit (% of GDP)				
IMF	4.0	-	3.8	-
European Commission	3.8	4.7	3.7	4.5
Consensus Forecast*	4.8	4.6	4.6	4.5
Fiscal deficit (% of GDP)				
IMF	4.0	4.1	3.9	4.0
European Commission	4.9	3.3	4.6	4.1
Consensus Forecast*	-	-	-	-

Sources: IMF (Republic of Serbia: Second Review under the Stand-By Arrangement, Country Report No. 15/296, IMF press release for Serbia, 10 November 2015), European Commission (Spring forecast 2015, Autumn forecast 2015) and Consensus Forecast (July and October 2015).

* Calculated based on the NBS projection of dollar GDP in July and October 2015.

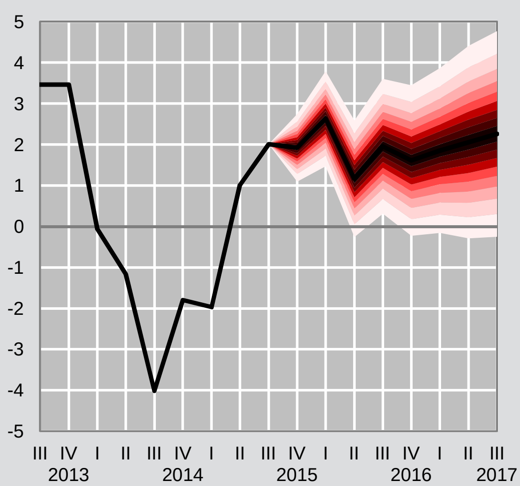
GDP projection

GDP is expected to grow by 0.8% in 2015 and to step up to 1.8% in 2016. GDP growth rates have been revised up by 0.3 pp relative to the previous projection as the rise in investment is estimated to be faster than expected. However, in contrast to the period 2011–2012, when investment growth was concentrated in oil and automotive industries, the on-going growth is broad-based.

Like in August, we expect that consistent fiscal adjustment and implementation of structural reforms will lead to higher investment and exports. At the same time, negative contribution to GDP in 2015 will originate from household and government consumption that will be weighed down by fiscal consolidation. However, the drop in oil prices, i.e. prices of petroleum products, has increased disposable household income which, together with a higher inflow of remittances and low and stable inflation, has made the fall in household consumption softer than anticipated. Judging by indicators of investment activity in recent months, investment will be higher this year than what we envisaged three months ago and this is the main reason why we have revised the GDP growth projection for 2015. Namely, Q3 witnessed a further rise in imports of equipment, newly granted investment loans and the number of issued construction permits. Though the recovery of external demand, especially demand from the euro area, benefits our exports, higher investment should also lead to an increase in imports since Serbia is an import-dependent economy. As a consequence, the contribution of net exports will be neutral this year.

On the production side, smaller final consumption is expected to dampen activity, notably in the service sectors. In addition to service sectors, negative contribution to this year's GDP will also originate from agriculture. In view of a very good agricultural season last year and below average this year (due to high temperatures and drought), agricultural production is estimated to slump by around 8% (10% under the August projection). On the other hand, the contribution of industrial production should be positive both on account of manufacturing and the recovery of production in the sectors of energy and mining. After significant flood damage to their capacities in 2014, energy and mining rebounded to their pre-flooding output levels and are likely to record two-digit growth rates this year. Besides, signs of recovery have cropped up in the construction industry over the past several months, which can be put down primarily to infrastructure projects. We therefore expect the contribution of construction industry to this year's GDP to be positive as well. A stronger growth in construction activity and a softer fall in agricultural production compared to what we envisaged three months ago are the main reasons on the production side why we have revised the GDP growth projection for 2015.

Chart V.0.8 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

Economic activity growth in 2016 should be led by investment and exports, and after four years, positive contribution is also expected from household consumption. Here also, growth has been revised up because of the expected increase in investment resulting from the reforms implemented thus far with a view to improving the business environment. However, due to higher imports of equipment, the contribution of net exports is likely to be almost neutral next year as well.

The risks to GDP projection are associated mainly with the speed of economic recovery of the euro area and further pace of fiscal consolidation and structural reforms at home, and to a lesser degree, with global oil and steel prices.

Even though the sustained low level of oil prices and the unconventional ECB measures could lead to its acceleration, the recovery of the euro area could be slowed down by the slackening growth of emerging markets, notably China, as the reduction in their import demand is bound to weigh down on euro area exports. The euro area being our main trade partner, Serbia would probably see a slowdown in its exports and consequently, GDP. Downside risks are also associated with global steel prices given their significant impact on the performance of the domestic steel industry.

On the other hand, the sustained low level of oil prices could serve as a fillip to GDP growth, through higher disposable household income, i.e. higher consumption, as well as through lower cost for enterprises. As regards internal factors, further consistent implementation of fiscal consolidation measures and structural reforms should have a positive effect on GDP in the medium term. Moreover, the expected increase in public sector efficiency and the reform of state-owned enterprises could also result in a faster than expected economic growth.

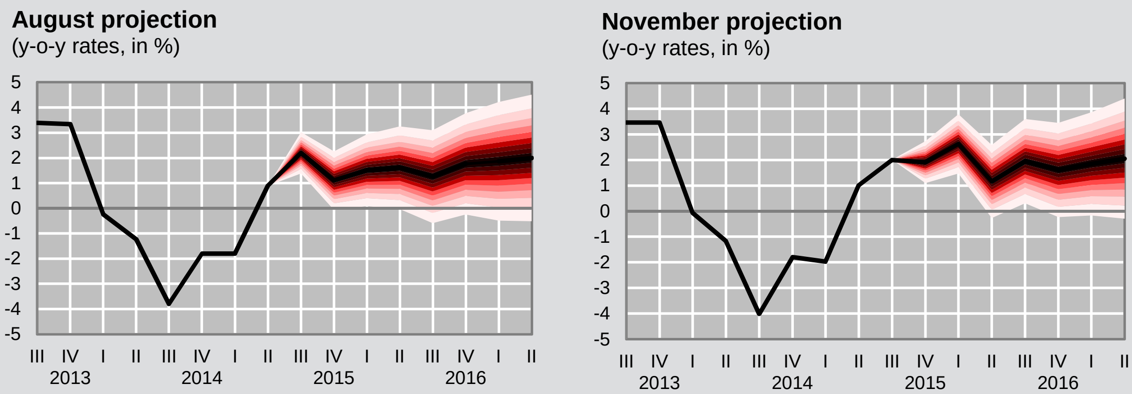
On balance, the risks to GDP projection are judged to be symmetric.

Comparison of projections and their outcome

Our new inflation projection is slightly lower than the one published in the August Report and the projected spread of inflation outcomes is skewed downwards as a result of the assessment that downside risks are more likely to materialise than those upside. The projected lower inflation reflects lowers inflationary pressures in Q3 (due to a sharper than anticipated fall in fruit and vegetable prices) and a somewhat slower than expected growth in prices of primary commodities.

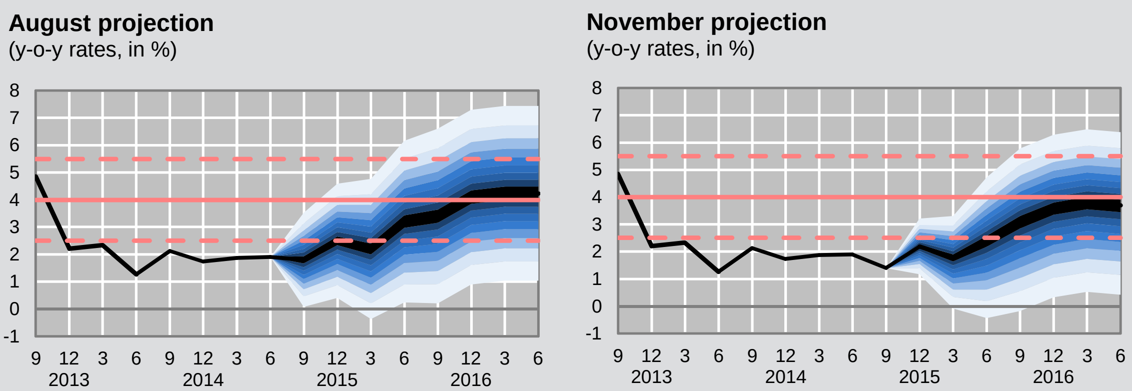
During the last year, y-o-y inflation was moving within the projection range from the November 2014 Inflation Report, trending however increasingly below the central projection rate in the last two quarters. Inflation deviated from the central projection rate because primary commodity prices (oil and primary agricultural

Chart V.0.9 **Current vs. previous GDP growth projection**



Source: NBS.

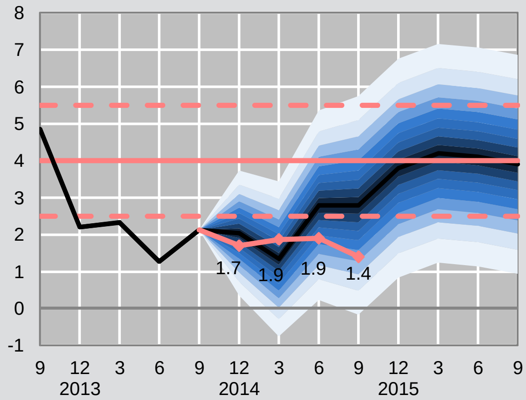
Chart V.0.10 **Current vs. previous inflation projection**



Source: NBS.

commodities) turned out to be much lower than assumed a year ago and because administered prices recorded a y-o-y fall in the first seven months of 2015 while we envisaged that they would grow.[34]

Chart V.0.11 **Achievement of November 2014 inflation projection**
(y-o-y rates, in %)



Source: NBS.

[34] See text box 3, p. 57.

Text box 3: Comparison of projections and their outcome

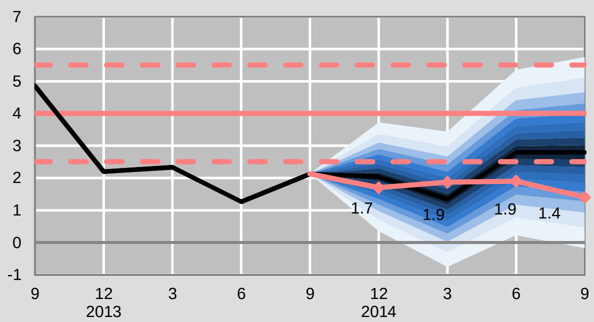
Central banks cannot fully and directly control all inflation factors. This is recognised when defining the target and making projections. Thus, the inflation target is defined with a tolerance band and the projections envisage potential deviation from the underlying assumptions on inflation factor movements. For this reason, inflation targeters, the NBS included, present their inflation projections in the form of a fan chart. This type of 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%. Each following shade includes additional 10% probability, which means that outturns of inflation somewhere within the entire fan chart are expected with probability of 90%. In other words, this graphical overview provides information on expected inflation movements over the next two years, but also on the degree of uncertainty surrounding the projection and on the balance of upside and downside risks to the central projection, which is reflected in the width of the projection band and the position of the central projection in relation to the band edges. For instance, if judged that inflation outturn is more likely to be below the central projection, i.e. that overall inflation factors in the coming period are likely to have a more disinflationary rather than inflationary effect than assumed, the larger part of the projection band in the fan chart will lie below the central projection.

Table O.3.1. **Projection assumptions - November 2014**
(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.

Chart O.3.1. **Achievement of November 2014 inflation projection**
(y-o-y rates, in %)



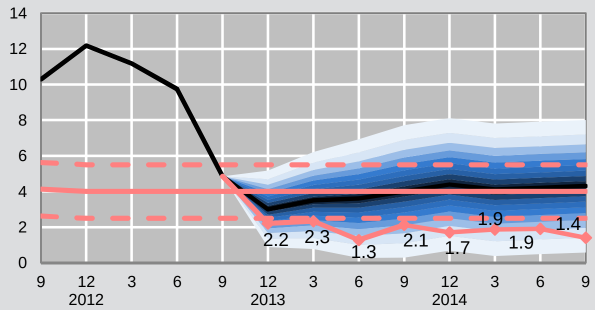
Source: NBS.

The most frequent, though not the only, cause of inflation's deviation from the projected path, are external shocks such as sudden changes in global food and energy prices. Though these prices have a distinct impact on inflation in Serbia, it is impossible to make reliable predictions on how they will evolve in the future. When defining the assumptions for these prices, the NBS takes into account the forecasts of relevant international institutions, the movement in commodity futures, but also subjective assessments and past experience regarding deviations of actual movements from projection assumptions. Forecasting inflation is made difficult also by the fact that there is no plan of administered price adjustment (electricity, postal services, utilities, some medicaments, etc).

It was precisely these factors – a sharp fall in global oil and primary agricultural commodity prices and the weaker than expected administered price growth – that delayed inflation's return within the target band in the course of this year. In November 2014, we projected inflation would return within the target tolerance band around mid-2015, conditioned on the assumption that oil prices would be around USD 88 per barrel at end-2015, that the growth in primary agricultural commodity prices in the international market would be close to 20% at annual level (as indicated by commodity futures at the time), and that administered prices at home would rise by around 10% adding some 2.0 pp to inflation. However, instead of that, primary agricultural commodity prices declined (the decline is estimated to be 6% at annual level) and oil prices will probably amount to USD 50 per barrel at year-end. Furthermore, administered price growth is most likely to reach 4.1% in 2015 (providing a 0.8 pp contribution to inflation), which is much lower than the multi-year average of around 10%. Because of this, y-o-y inflation has been moving below the central projection, but nevertheless within the November 2014 projection range.

Looking at the longer projection horizon, for instance our forecast from November 2013 (see Chart O.3.2), we can see that inflation outturn was within the projection range all the time. This means that the NBS correctly assessed the risks and the width of the projection range. Thus, for instance, when explaining the risks to the projection in November 2014, we underlined that downside risks to the growth in prices of primary agricultural commodities in 2015 appeared stronger than those upside and that there was a possibility that the electricity price increase would not take place in April 2015. On the other hand, upside risks to the projected inflation path were associated mainly with developments in the international environment and potential volatility in capital flows towards emerging markets, Serbia included, because of the on-going geopolitical tensions and the anticipated increase in the Fed's policy rate. This made the risks to the projection broadly balanced. However, as only downside risks materialised in the period under review, inflation was lower than the central projection rate.

Chart O.3.2 **Achievement of November 2013 inflation projection**
(y-o-y rates, in %)



Source: NBS.

Table A
Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Q1 2015	Q2 2015	Q3 2015
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	7.6	6.6	6.9	6.7	6.8[2)]
FX reserves/short-term debt	177.0	265.1	250.6	162.6	220.6	191.2	298.3	240.1	268.5	291.4	311.0	300.7	306.2
FX reserves /GDP	23.3	36.9	32.7	24.2	34.6	33.6	36.1	34.5	32.7	30.0	32.2	31.7	32.3
Debt repayment/GDP	5.0	10.3	10.3	10.7	12.8	12.0	12.4	13.1	13.3	14.3	12.3	10.6	11.4
Debt repayment/exports of goods and services	19.8	36.2	37.5	37.5	48.8	37.5	37.3	36.2	32.6	32.7	25.0	21.6	24.2
EXTERNAL SOLVENCY INDICATORS (in %)													
External debt/GDP	59.3	58.5	59.0	62.3	72.7	79.0	72.2	80.9	75.1	78.0	81.9	81.6	80.8
Short-term debt/GDP	13.2	13.9	13.1	14.9	15.7	17.6	12.1	14.3	12.2	10.3	10.4	10.5	10.5
External debt/exports of goods and services	234.9	205.7	214.3	218.9	276.9	247.1	216.5	223.6	184.7	178.5	182.1	176.6	171.4
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	278.1	318.8	292.0	277.4
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	199.9	196.6	201.9	193.6	204.3
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	70.8	77.4	80.1	82.6	69.0	79.8	82.7	89.8	92.6	98.4	110.6	107.5	102.5[2)]
MEMORANDUM: (in EUR million)													
GDP[1)]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,075	7,196	8,132	8,554[2)]
External debt	12,520	14,291	17,382	20,982	22,272	23,509	24,123	25,645	25,747	25,792	26,719	26,512	26,308
External debt servicing	1,054	2,513	3,039	3,594	3,922	3,564	4,154	4,155	4,543	4,720	883	863	978
Central bank foreign exchange reserves	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	9,907	10,515	10,293	10,511
Short-term debt[3)]	951	968	1,044	1,832	1,843	1,752	601	455	196	102	164	185	219
Current account balance	-1,778	-2,356	-5,474	-7,126	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-520[2)]	-257[2)]	-306[2)]

CREDIT RATING (change of rating and outlook)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
	July/May	Feb	July	March/ Dec	Dec	Nov	March	Aug	July	Jan
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 (excl. early repayment of a part of debt to London Club creditors) to GDP during period under review.

Debt repayment/exports (in %) - ratio of debt repayment (excl. early repayment of a part of debt to 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 ESA 2010.

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 imports 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 now includes liabilities under SDR allocation (EUR 485.2 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 940.8 mln, of which EUR 422.4 mln relates to domestic banks and EUR 518.4 mln to domestic enterprises).

5. Foreign 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	2014	Q1 2015	Q2 2015	Q3 2015
Real GDP growth (in %)[1)]	5.5	4.9	5.9	5.4	-3.1	0.6	14	-10	2.6	-18	-2.0	10	2,0
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	17	19	19	14
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	9,907	10,515	10,293	10,511
Exports (in EUR million)[3)]	5,329	6,948	8,110	9,583	8,043	9,515	11,145	11,469	13,937	14,451	3,529	3,992	4,045
- growth rate in % compared to a year earlier	19.1	30.4	-	18.2	-16.1	18.3	17.1	2.9	21.5	3.7	6.8	9.2	9.1
Imports (in EUR million)[3)]	9,612	11,970	15,468	18,267	13,099	14,244	16,487	16,992	17,782	18,096	4,434	4,754	4,724
- growth rate in % compared to a year earlier	0.7	24.5	-	18.1	-28.3	8.7	15.7	3.1	4.7	18	7.1	3.9	18
Current account balance[3)]													
(in EUR million)	-1,778	-2,356	-5,474	-7,126	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-520,1[6)]	-256,8[6)]	-305.7[6)]
as % of GDP	-8.4	-9.6	-18.6	-21.1	-6.6	-6.8	-10.9	-11.6	-6.1	-6.0	-7,2[6)]	-3,2[6)]	-3,6[6)]
Unemployment according to the Survey (in %)	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	19,4[7)]	19.2	17.9	
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	379.3	344.0	371.3	372.5
RS budget deficit/surplus (in % of GDP)[4)]	0.5	-17	-16	-17	-3.2	-3.4	-4.0	-5.9	-5.2	-6.4	-2.5	-0.5	-0.8
Consolidated fiscal result (in % of GDP)[4)]	12	-15	-19	-2.6	-4.4	-4.6	-4.8	-6.8	-5.5	-6.7	-2.4	-14	-15
RS public debt, (central government, in % of GDP)	50.2	35.9	29.9	28.3	32.8	41.8	45.4	56.2	59.6	71.0	75.2	73.7	73.4
RSD/USD exchange rate (period average)	66.87	67.03	58.39	55.76	67.47	77.91	73.34	88.12	85.17	88.54	108.15	108.86	108.06
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	99.46	111.42	107.73	106.49
RSD/EUR exchange rate (period average)	82.99	84.11	79.96	81.44	93.95	103.04	101.95	113.13	113.14	117.31	121.50	120.44	120.21
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	120.96	120.22	120.60	119.75
MEMORANDUM:													
GDP (in EUR million)[5)]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,075	7,196	8,132	8,554[6)]

[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 break in 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 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)] Includes below-the-line items (payment of called guarantees, bank recapitalisations and debt takeover) in line with IMF methodology, as of 2008 on RS budget level and as of 2005 on consolidated level.

[5)] According to ESA 2010.

[6)] NBS estimate.

[7)] Revised data for 2014 according to new methodology of Labour Force Survey.

Notes:

1. Data are subject to corrections in line with 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

NNATIONAL BANK OF SERBIA
GOVERNOR
GO. No 943/2/15

Belgrade, 15 September 2015

GOVERNMENT OF THE REPUBLIC OF SERBIA
Mr Aleksandar Vučić, Prime Minister[1]

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), I am writing this open letter to inform you that consumer price growth in August equalled 2.1% year-on-year. This was the sixth consecutive month of inflation moving below the lower bound of the target tolerance band (4.0±1.5%), since March 2015 when the previous open letter was addressed to you in an effort to explain the reasons for the undershooting. This letter explains why inflation has moved away from the target tolerance band, describes the policy action that has and will be taken with a view to bringing back and maintaining inflation within the target tolerance band in the medium term, and sets out the horizon over which we expect inflation to return within the band.

In our letter of March 2015 we expressed our expectation that in the latter half of the year inflation would return within the target tolerance band on the back of past monetary measures and the anticipated adjustment in administered prices, assuming as well the waning of the effect of the drop in prices of primary commodities. However, the movement in international primary commodity prices, notably the collapse of oil prices from July 2015, perpetuated the disinflationary role of primary commodities into the second half of 2015. The unusually sharp fall in fruit and vegetable prices (especially in July) caused inflation to be 0.4 pp lower than initially projected for the period March–August 2015. Also, due to the adjustment of electricity prices, the year-on-year administered price growth re-entered the positive territory in August, which is later than we expected.

The National Bank of Serbia has taken measures within its remit in order to bring inflation back within the target tolerance band in the medium run.

As the key policy rate has been cut since March by 300 bp to 5%, the weighted average interest rate on one-week repo operations of the National Bank of Serbia is now revolving around 3.5%. The reduction of the key policy rate has also been accompanied by the fall in interest rates in the credit and interbank money markets. In its last meeting held on 10 September 2015, the National Bank of Serbia's Executive Board decided to cut FX reserve requirement ratio by one percentage point in each of the next six months. Significant FX and dinar funds will be released to banks in this way, which will enable further lowering of lending rates, support credit activity and reflect positively on the pace of economic recovery.

Successful implementation of fiscal consolidation measures and the arrangement with the International Monetary Fund facilitated monetary policy easing and led to the narrowing of internal and external imbalances and improved investment environment.

In view of the expected effects of its monetary policy measures, the National Bank of Serbia judges that year-on-year inflation will be moving around the lower bound of the target tolerance band (2.5%) over the coming twelve months. There is however a possibility that inflation will enter the band late this year or early next year. We expect inflation will steadily trend closer to the 4% target from mid-2016, and this expectation is also shared by the financial market and businesses.

As so far, the National Bank of Serbia will continue to act responsibly and consistently in pursuing monetary policy objectives, thereby contributing to macroeconomic stability and economic growth.

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

Index of charts and tables

Charts

Tables

Charts in text boxes

Tables in text boxes

Executive Board meetings and changes in the key policy rate

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	8.00	0

2015

Date	Key policy rate (p.a, in %)	Change (in basis points)
15 January	8.00	0
12 February	8.00	0
12 March	7.50	-50
9 April	7.00	-50
11 May	6.50	-50
11 June	6.00	-50
9 July	6.00	0
13 August	5.50	-50
10 September	5.00	-50
15 October	4.50	-50
12 November	4.50	0
10 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 10 September 2015

The NBS Executive Board decided in its meeting today to cut the key policy rate by half a percentage point, to 5.0 percent.

After reviewing current monetary and macroeconomic developments and projections, the Executive Board stated that inflationary pressures remain low and inflation expectations anchored within the NBS target. Subdued inflationary pressures reflect in particular low international prices of primary commodities, low inflation abroad, relatively stable exchange rate of the dinar and the effects of fiscal consolidation at home. Though the August increase in electricity prices has pushed y-o-y administered price growth into the positive territory, the contribution of administered prices to inflation this year should be smaller than in the previous years. As a result of past monetary policy easing and the gradual waning of the disinflationary effects of the fall in primary agricultural commodity prices, inflation is expected to revolve around the lower bound of the target band (2.5%) in the coming period, possibly entering the target band in late 2015 or early 2016. Inflation is expected to trend closer to the 4% target from mid-2016.

The Executive Board has assessed that the resilience of the domestic economy towards the risks stemming from the international environment has increased owing in particular to fiscal consolidation, improved economic growth prospects, reduced external imbalances, and the expectation of another positive assessment of Serbia’s arrangement with the IMF (second review).

In light of subdued inflationary pressures, the decision to continue monetary easing – by reducing both the key policy rate and the reserve requirement ratio, shall certainly contribute to Serbia's incipient economic recovery. When making the decision, the Executive Board was also bearing in mind the ECB’s downward revision of the euro area economic growth projection and the possibility that the quantitative easing programme will be extended. In an environment of increased certainty that the Fed will start raising its policy rate, the ECB’s quantitative easing programme has been having a positive impact on liquidity in the international financial market and has lessened the risks associated with capital flows towards emerging economies.

The next rate setting meeting of the NBS Executive Board will be held on 15 October 2015.

Press release from Executive Board meeting held on 14 October 2015

The NBS Executive Board decided at its meeting today to cut the key policy rate by half a percentage point, to 4.5 percent.

The Executive Board stated that y-o-y inflation continued moving below the lower bound of the target tolerance band, measuring 1.4 percent in September 2015. Inflationary pressures remain subdued as a result of low inflation abroad and low prices of primary commodities, but also relative stability of the dinar exchange rate underpinned by the country’s improved macroeconomic performance, notably in terms of favourable fiscal and balance of payments developments. This is evidenced by the primary fiscal surplus in the first eight months of the year and by the full coverage of the current account deficit by the inflow of foreign direct investments. Inflation expectations remain firmly anchored within the NBS target band, and even lower than the 4 percent target in the case of the financial sector.

Past monetary policy easing and gradual waning of disinflationary effects of the drop in primary agricultural commodity prices should help steer y-o-y inflation back within the target tolerance band early next year, while inflation’s return to the 4 percent target is expected from mid-2016.

The Executive Board expects that continued monetary easing through key policy rate cuts and gradual trimming of the required reserves ratio will encourage further lowering of bank lending rates and the recovery of lending activity.

In deciding on the key policy rate, the Executive Board took account of the global slowdown in economic growth, which could result in longer than expected pursuit of accommodative monetary policies by advanced economies. This would have a positive impact on liquidity in the international financial market, mitigating risks regarding capital flows to emerging economies.

The Executive Board has assessed that the improved macroeconomic outlook of the country is sustained by fiscal consolidation and structural reforms, reduced external imbalances and the anticipated second positive review of the arrangement with the IMF.

The next rate-setting meeting of the Executive Board will be held on 12 November 2015.

Press release from Executive Board meeting held on 12 November 2015

In its meeting today, the NBS Executive Board decided to keep the key policy rate unchanged at 4.5 percent.

This decision was made in consideration of the expected effects of past key policy rate cuts and gradual trimming of the FX reserve requirement ratio on inflation movements in the period ahead in an environment of persistent external risks. Uncertainties over the coming period mostly relate to divergent monetary policies of leading world economies. An increase in the Fed funds rate could have a negative impact on liquidity in the international financial market, hindering capital flows to emerging markets. However, the Executive Board assesses that the resilience of the Serbian economy to the above external risks is bolstered by the effects of fiscal consolidation measures, better than anticipated growth prospects, reduced external imbalance and consistent implementation of the arrangement with the International Monetary Fund.

After reviewing current monetary and macroeconomic developments and projections, the Executive Board stated that inflationary pressures remain subdued, reflecting chiefly low inflation abroad, low prices of primary commodities in the international markets, relative stability of the exchange rate, positive effects of fiscal consolidation and a further fall in inflation expectations. Y-o-y inflation is expected to temporarily return within the target tolerance band in early 2016 as a result of the drop-out from calculation of last year’s decrease in prices of petroleum products and cigarettes. A more durable stabilisation of inflation within the target band is expected from mid-2016.

At its meeting today, the Executive Board also adopted the November Inflation Report that will be presented to the public on Thursday, 19 November.

The next rate-setting meeting of the Executive Board will be held on 10 December 2015.

CIP - Каталогизација у публикацији
Народна библиотека Србије, Београд

336.71(497.11)

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

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