National Bank of Serbia

November 2016

INFLATION REPORT

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Introductory note

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

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

The *Inflation Report* aims to cover information on the current and expected inflation movements and to provide an 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 at its meeting of 10 November 2016.

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
BRICS – Brazil, Russia, India, China and South African Republic
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
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 low as a result of the disinflationary effect of the majority of domestic factors and low cost-push pressures from the international environment.

Inflationary pressures remained low in the third quarter of 2016 under the influence of the majority of domestic factors, continued low cost-push pressures from global prices of oil and primary agricultural commodities, and low inflation abroad, particularly in the euro area. Quarter-on-quarter, consumer prices increased by 0.2%, undershooting our expectations stated in the August *Report*, as fruit and vegetable prices fell more sharply due to favourable weather conditions, and fresh meat prices increased less than expected mostly due to their higher than expected drop in September. As a result of the low base effect for petroleum products and unprocessed food and the drop-out from the annual comparison of last year's increase in electricity prices, at 0.6% in September, year-on-year inflation was marginally higher than at the end of the previous quarter. Core inflation also continued to move below the lower edge of the target tolerance band (1.6% in September).

In the period since the August Report, developments in the international environment were marked by more favourable euro area growth prospects for 2017, a rise in global oil prices at the close of the third quarter and continued uncertainty regarding future monetary policy measures of leading central banks.

Growth prospects of the euro area, our key trade partner, for 2017 have improved from three months ago as the negative effects of Brexit were less pronounced than initially expected. Uncertainty in the international financial market continues with regard to future monetary policy moves of leading central banks, i.e. their possible impact on global capital flows. So far, the European Central Bank has not changed its policy rate or its asset purchase programme, pointing out that monetary policy measures in place since June 2014 underpin the momentum of euro area economic recovery. However, as market participants expected the asset purchase programme to be extended until September 2017, October saw increased volatility in the European financial market. Uncertainty in the international commodity market was associated with movements in oil prices which rose at the close of the third quarter amid announcements of production capping by the world's largest producers. But the rise was, however, not sustained in October.

The Executive Board cut the key policy rate to 4.0% in July and kept it on hold in the months that followed.

The key policy rate of the National Bank of Serbia was cut to 4.0% in July and kept on hold in the months that followed. The decisions of the Executive Board were taken in consideration of the inflation outlook and the expected effects of past key policy rate cuts on future inflation profile in the context of the above mentioned

uncertainties in the international environment. The Board assessed that a sustainable narrowing of internal and external imbalances has been achieved, enhancing the resilience of Serbia's economy to external shocks. This has been reflected in a notable reduction of the country's risk premium in the third quarter. This reduction resulted from the narrowing of internal and external imbalances and a more favourable outlook, but was also supported by a positive assessment of the International Monetary Fund with regard to successful completion of the fourth and fifth reviews of the precautionary stand-by arrangement and a relatively quick stabilisation of the international financial market in the wake of Brexit.

Appreciation pressures prevailed from July onwards, amid growing demand of non-residents for Serbian government securities.

In the conditions of further narrowing of foreign trade and fiscal imbalances and a reduction in the country's risk premium, growing demand of non-residents for dinar government securities gave rise to appreciation pressures on the dinar, particularly at the start of the quarter under review. The National Bank of Serbia intervened by buying foreign exchange to moderate short-term appreciation pressures. At end-October, the value of the dinar against the euro was almost unchanged relative to end-June.

Considerable past monetary policy easing continued to have a positive effect on the money and loan markets.

Thanks to past monetary easing and continued fiscal adjustment, the cost of borrowing for the government decreased further during the third quarter. At the same time, past monetary easing, low euro area rates, lower risk premium and increased interbank competition resulted in lower rates on new loans (by 0.5 percentage points), primarily to corporates. As a result of the above factors and the acceleration in economic activity, the growth in lending continued, speeding up to 4.3% in September in year-on-year terms. Additionally, some banks began to offer housing loans in dinars with a repayment period of up to 30 years and an interest rate below 5%, which is yet another confirmation of the achieved monetary policy results and macroeconomic stability.

Owing to excellent results in fiscal consolidation, the share of public debt in GDP began declining this year, a year earlier than initially expected.

Austerity measures on the expenditure side of the budget provided the key contribution to the notable narrowing of fiscal imbalances in the past two year. An increasing contribution is also coming from the revenue side, primarily as a result of improved tax collection and faster economic growth. The consolidated budget deficit in the nine months of this year came at around 0.1% of GDP, compared to 1.8% of GDP in the same period last year. With interest expenses excluded, a surplus of 3.5%

of GDP was recorded at general government level. During their October mission, the representatives of the International Monetary Fund gave a positive assessment of Serbia's economic performances and the overshooting of fiscal targets. The projected deficit for 2016 has been revised down to 2.1% of GDP. Substantial fiscal efforts support the sustainability of public debt whose share in GDP decreased in 2016 for the first time since 2008.

External imbalances narrowed further, with the current account deficit fully covered by the net inflow of foreign direct investment.

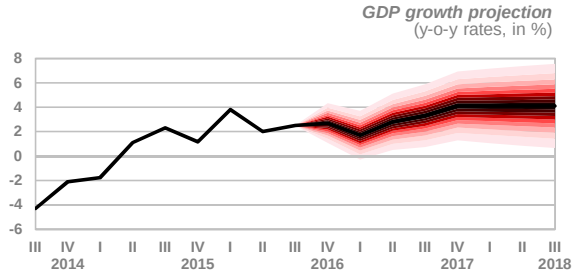
Foreign trade imbalances continued to narrow as exports of goods and services grew much faster than imports. In the nine months of the year, the current account deficit was reduced by more than 20% from the same period a year earlier, and was more than fully covered by the net inflow of foreign direct investment. Thanks to an improved business environment and structural reforms, net inflow of foreign direct investment in 2016 will remain at last year's level, retaining its relatively high share in GDP (around 5.2%). We estimate that the share of the current account deficit in GDP will decrease by around 0.6 percentage points this year to 4.1% of GDP.

Economic activity increased more than expected in the third quarter, rising according to our estimate by 0.5% from a quarter earlier and by 2.5% relative to the same period last year.

As a result of a successful agricultural season and continued favourable trends in industry and construction, economic activity in the third quarter increased more than expected; according to our estimate, it rose by 0.5% from a quarter earlier or by 2.5% relative to the same period last year. The growth in physical volume of industrial production accelerated to 3.6% year-on-year, propped up primarily by manufacturing which continued to record growth across two-thirds of industries thanks to the activation of earlier investments, lower operating expenses and economic recovery in the euro area. Also, the completion of overhauls in a number of electric-energy plants pushed up the physical volume of production in mining and electricity, gas and steam supply. On the expenditure side, GDP growth in the third quarter was led by investment, with net exports also providing a positive contribution. Conversely, household consumption stagnated, after growing for four quarters in a row.

The pace of economic recovery should accelerate to around 2.7% this year and around 3.0% in 2017, led by investment and exports but also by the rise in final consumption.

According to our estimate, GDP will rise by around 2.7% this year owing to an excellent agricultural season and improved trends in manufacturing, construction and some service sectors, and will speed up to around 3% in 2017. Further acceleration of economic growth is expected thereafter. On the expenditure side, in 2017 as well, GDP growth will be led by investment based on



continued intensive implementation of infrastructure projects and an improved investment environment, supported by a reduction in operating expenses on account of interest rates on existing loans and by the lower cost of new borrowing. Final consumption is also expected to provide a positive contribution amid expected rise in employment and private sector wages, higher disposable income based on lower cost of borrowing and, to a degree, the announced increase in minimum wages, public sector wages and pensions. The contribution of net exports will remain positive in 2017 as well.

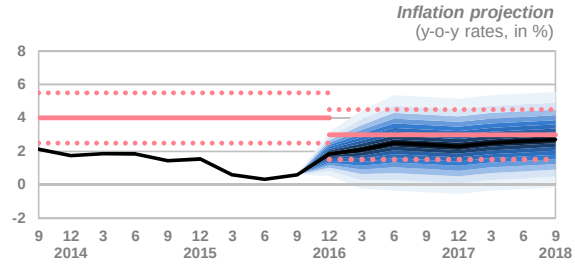
The improvement in Serbia's business and investment environment has also been confirmed by the country's progress on international competitiveness rankings.

Substantial improvement in Serbia's business and investment environment has been reflected in the country's improved ranking on the World Bank's Doing Business 2017 list for the second year in a row. This year, Serbia was among the global top ten improvers with regard to ease of doing business, with its place in the global ranking stakes improving from 54 to 47. According to the latest Global Competitiveness Report of the World Economic Forum for 2016, Serbia improved most within the macroeconomic environment indicator where its ranking improved by 22 positions. Within the macroeconomic environment pillar, Serbia ranked first in terms of inflation, like in the previous year, sharing this position with other 35 countries.

Considerable improvement in macroeconomic fundamentals and prospects and the achievement of price stability enabled the lowering of the inflation target to 3.0% ± 1.5 percentage points from 2017.

Significantly improved macroeconomic fundamentals and prospects, primarily a sustainable narrowing of external and internal imbalances and a lower risk of investing in Serbia enabled by successful coordination of monetary and fiscal policies, were the key reasons for inflation target revision to 3.0%±1.5 percentage points from 2017 onwards. Another important factor behind the revision of the target are inflation expectations of the financial and corporate sectors which have already fallen to the new target level and have been relatively stable for an extended period of time, thereby confirming increased credibility of the National Bank of Serbia's monetary policy.

According to our latest projection, year-on-year inflation will make its way back within the new target tolerance band (3.0% ± 1.5 percentage points) early next year.



According to our central projection, year-on-year inflation will start rising in the coming months, make its way back within the new target tolerance band (3.0% ± 1.5 percentage points) early next year, and stay therein until the end of the projection horizon. The rise in inflation will be driven by the low base effect for petroleum product prices and a gradual pick-up in aggregate demand at home and inflation abroad, while low food production costs resulting from this year's good agricultural season and a further cut in prices of primary agricultural commodities in the third quarter,

will hold inflation back. The risks to the projected inflation path are symmetric, relating primarily to future developments in international commodity and financial markets and, to a certain degree, to administered price growth next year.

The new inflation projection for 2017 is lower than the one published in the August Report, and the projected inflation range remains symmetric. The lower projected inflation is attributable primarily to the downward revision of assumptions regarding global prices of primary agricultural commodities and lower than assumed administered price growth this year, which will remain in the calculation of year-on-year inflation over a one-year horizon.

The new inflation projection is lower due primarily to the downward revision of assumptions regarding global prices of primary agricultural commodities and lower than expected administered price growth this year.

Looking ahead, monetary policy decisions of the National Bank of Serbia will continue to depend on the Executive Board's assessment of the intensity of the (dis)inflationary impact of inflation factors, notably those coming from the international environment. As before, the National Bank of Serbia will keep a close eye on developments in the domestic market and international primary commodity and financial markets.

The monetary policy stance in the period ahead will continue to depend primarily on developments in the international environment.

II. Monetary policy since the August Report

After lowering the key policy rate to 4.0% in July, the NBS Executive Board kept the rate unchanged in the months that followed.

The Executive Board's decisions were influenced by the inflation projection, the expected effects of past rate cuts on inflation profile in the period ahead, and uncertainties in the international environment. Uncertainties were particularly high with respect to oil price movements and future policy moves of the Fed and the ECB and, hence, global capital flows.

In making the decision to keep the key policy rate unchanged in November, the Executive Board, among other things, took into consideration the fact that the inflation target for 2017 has been lowered to 3.0%±1.5 percentage points on account of the substantial improvement in macroeconomic performances and prospects.

Since the August *Report*, decisions on monetary policy were based on the August inflation projection forecasting inflation's return within the target tolerance band in H1 2017, where it would remain until the end of the projection horizon. These assumptions on inflation movements were based on the low-base effect of the prices of petroleum products, and a gradual increase in aggregate demand at home and inflation abroad. On the other hand, low food production costs were expected to continue to slow inflation down for some time yet. The risks to the August inflation projection were symmetrical and pertained mostly to movements in international primary commodity prices and developments in the global financial market, and, to some extent, to the rise in administered prices at home. As regards economic activity, more favourable trends in manufacturing, construction and some service sectors raised expectations that GDP growth would accelerate to 2.5% in 2016, the upper bound of the May projection. At the same time, GDP growth was expected to step up to around 3% in 2017.

In consideration of such inflation and GDP projections, as well as incoming information on developments in the country and abroad, the NBS Executive Board **kept the key policy rate unchanged at 4.0% from August to November**. Decisions were taken primarily in view of the anticipated effects of past key policy rate cuts on inflation movements in the period ahead, and uncertainties prevailing in the international commodity and financial markets.

The Executive Board expected that the effects of past monetary policy easing and the recovery of domestic demand and inflation abroad would help return inflation within the target tolerance band around mid-2017 and keep it within the band thereafter.

A cautious monetary policy stance of the NBS in this period was also warranted by persistent uncertainties in the international commodity markets and the anticipated recovery in oil prices. Global oil prices started recovering as leading world producers announced their intention to limit output, which should, along with the low-base effect of petroleum product prices, contribute to a gradual rise in y-o-y inflation in the coming period.

Caution in the conduct of monetary policy was also advised because of uncertainties in the international financial market over future monetary policy moves of leading central banks and their potential impact on global capital flows. Key issues for investors in the international financial market related to the pace of the Fed's policy normalisation, the UK's withdrawal from the EU, and the

continuation of the ECB's asset purchase programme. Although Brexit caused a shock of a regional rather than global character, it increased macroeconomic uncertainty in the euro area, our key trade partner.

Despite the uncertainties abroad, the improvement in domestic performance was conducive to monetary policy implementation. For this reason, continued successful implementation of fiscal consolidation and structural reforms, as well as the narrowing of external imbalances, is essential for the monetary response of the NBS, as this will strengthen the resilience of the domestic economy to potential negative effects from the international environment. That this process is actually taking place is confirmed by a considerable decline in Serbia's risk premium, which fell in September to its nine-year low. In addition, the high level of FX reserves ensures effective prevention of potential negative effects of the volatility of short-term capital flows.

In making the decision to keep the key policy rate unchanged in November, the Executive Board took into consideration the inflation projection and the effects of past monetary easing on inflation movements in the period ahead, as well as the fact that the **inflation target for 2017 has been revised down to 3.0%±1.5 pp** on account of the substantial improvement in macroeconomic performances and prospects. The Executive Board underscored that year-on-year inflation will rise gradually in the coming months, return within the new target tolerance band early next year and move within the band thereafter.

Such movements in inflation are anticipated based on the effects of past monetary easing and the recovery of domestic demand, coupled with a gradual increase in global oil prices and inflation abroad. On the other hand, the disinflationary impact of a further drop in prices of primary agricultural commodities at home and abroad owing to a good agricultural season, and the resulting low food production costs, will continue to be felt for some time to come.

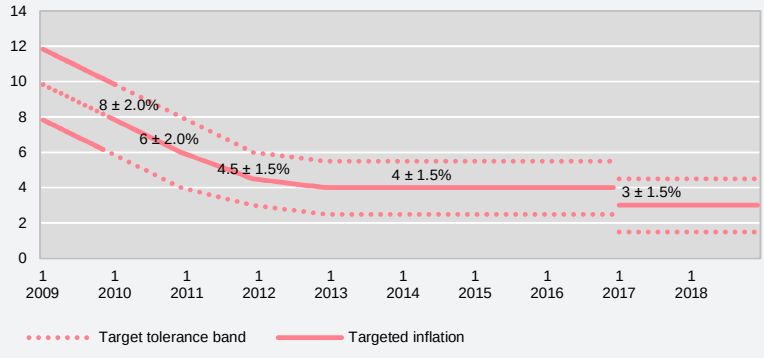
Monetary policy caution is still mandated by uncertainties in the international financial market concerning future measures of the Fed and ECB, and their potential impact on global capital flows. However, as the Executive Board concluded, successful implementation of fiscal consolidation and structural reforms, including the narrowing of external imbalances, increase the resilience of the domestic economy to potentially adverse effects from the international environment. This is confirmed by the IMF's positive assessment following their October visit, a falling country risk premium and progress on international competitiveness rankings based on the improvement of the country's business and investment climate.

Text box 1: Revision of the inflation target to 3.0% ± 1.5 pp from 2017

In November this year, the National Bank of Serbia and the Government of the Republic of Serbia agreed to lower the inflation target for 2017 and 2018 by 1.0 pp to 3.0% ± 1.5 pp.[1]

The key reason for target reduction is the significant improvement in macroeconomic fundamentals and prospects, including primarily a sustainable narrowing of external and internal imbalances and a lower risk of investing in Serbia. This has been achieved through successful coordination of monetary and fiscal policy measures, as well as excellent fiscal consolidation results. As a result of well-calibrated monetary policy measures and their full coordination with fiscal policy measures, inflation in Serbia has been at a low and stable level over the past three years, comparable with that of developed countries and consistent with the new target.

Chart O.1.1 **Inflation targets**
(y-o-y rates, in %)



Source: NBS.

Another important reason for target revision are the inflation expectations of the financial and corporate sectors which have been reduced and relatively stable for an extended period of time, confirming the increased credibility of the National Bank of Serbia's monetary policy. Namely, these sectors expect y-o-y inflation to move between 2.0% and 3.0% over the next two years, which is close to the new target level and facilitates its achievement. Generally speaking, adjustment of inflation expectations is the greatest challenge faced by policy makers when deciding on target reduction, but in our case this adjustment has already been achieved.

In addition, administered prices are rising at a much slower pace than anticipated earlier. And while in the period to 2013 administered prices increased at a rate of around 10% p.a., contributing 2.0 pp to inflation, their growth over the past two years has been much lower. This year, administered prices are expected to rise by around 2% (contributing 0.4 pp to inflation). As this change reflects the Government's commitment to address inefficiencies in public enterprise operation by downsizing their operating expenses rather than by raising the prices of their goods and services as was the case before, relatively low growth in administered prices is likely to continue in the period ahead.

The lowering of the inflation target confirms the commitment of both the National Bank of Serbia and the Government for Serbia to remain in the ranks of European countries with low and stable inflation. In this regard, we may expect the following:

– Uncertainties in business will abate further and investment climate will improve, given that, as a rule, lower inflation rates lead to more stable inflation movements. According to one of the competitiveness criteria of the World Economic Forum, the optimal inflation rate interval is 0.5–2.9%. In terms of this criterion, Serbia ranked first in the previous two years (2014 and 2015), which we expect to remain unchanged in the coming period;

[1] Memorandum of the National Bank of Serbia on Inflation Targets until 2018 (consolidated version).

– Long-term interest rates on dinars will decline and the use of the dinar in lending and savings will increase. This should lead to a reduction in the costs and currency risk of financing long-term needs of corporates, households and the government. At the same time, higher dinarisation will improve the effectiveness of monetary policy measures.

In the prior period, the target was kept at 4% due to expectations of faster convergence of prices in Serbia towards those in the euro area. However, the convergence process has lost pace over the past years and is likely to remain subdued in the period ahead. Moreover, other countries have also resorted to target reduction even though not only have they not completed the process of convergence towards the EU, but have at times experienced even a reversal of the process. Though lowered, at 3% the inflation target is still higher than in developed countries, which makes room for continuation of the convergence process.

The target tolerance band has remained unchanged at ±1.5 pp which reduces the need for frequent monetary policy reactions, and at the same time contributes to greater predictability of the monetary policy and enhanced stability of monetary conditions. In addition, the volatility of global prices of primary commodities, primarily energy and agricultural commodities, can still trigger increased volatility of headline inflation. Also, Serbia, as a small and open economy, continues to be exposed to external shocks which could affect inflation through their impact on the risk premium and the exchange rate. Still, the narrowing of external and internal imbalances has contributed greatly to the resilience of the domestic economy to these potentially adverse effects. Finally, the relatively wider target tolerance band leaves more scope for the National Bank of Serbia to pursue its second objective – financial stability and to support the economic policy of the Government of the Republic of Serbia which is conducive to sustainable economic growth.

III. Inflation movements

Inflationary pressures remained subdued in Q3 under the influence of the majority of domestic factors, continued weak cost-push pressures from global prices of oil and primary agricultural commodities and the persistent low inflation in the international environment, particularly in the euro area, our main trade partner. Prices grew slightly at the quarterly level, led by prices of fresh meat and cigarettes, while fruit and vegetable prices worked in the opposite direction.

An extended period of relatively low inflation expectations confirms that economic agents expect the prices to remain stable both in the following year and in the medium run.

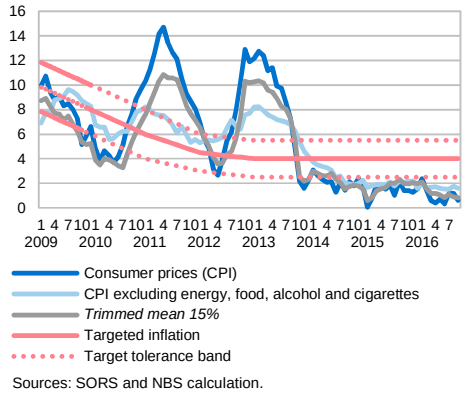
Inflation movements in Q3

Consistent with expectations presented in the August *Report*, y-o-y inflation continued to move below the lower limit of the target tolerance band in Q3. It measured 0.6% in September, having received a negative contribution from prices of fruit and vegetables (-0.6 pp) and petroleum products (-0.1 pp), and a positive contribution from prices of non-food products and services (0.6 pp), administered prices (0.4 pp) and prices of industrial food products (0.3 pp). Since last year's increase in the price of electricity[1] dropped out of the calculation of y-o-y inflation, the contribution of administered prices halved at end-Q3 relative to Q2.

On the whole, consumer prices rose by 0.2% in Q3, which is lower than expected, as fruit and vegetable prices dropped more than usual for the season and prices of fresh meat rose less than expected.

The impact of food prices on quarterly inflation was negative again in Q3 (0.2 pp). **Unprocessed food** prices declined (2.1%), while processed food prices increased (0.4%). Within unprocessed food, vegetable prices lost 20.0% (contribution: -0.8 pp), mainly in July. Fruit prices also fell, albeit to a lesser extent (1.4%, contribution: 0.03

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



Sources: SORS and NBS calculation.

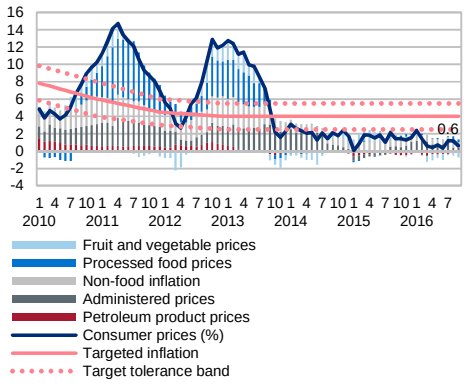
[1] Last year, the price of electricity was increased in August.

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

	Share in CPI	2015 IV	2016 I	2016 II	2016 III
Consumer prices (CPI)	100.0	-0.5	0.4	0.5	0.2
Unprocessed food	11.6	-5.9	5.5	-0.6	-2.1
Processed food	20.5	-0.3	0.9	-0.3	0.4
Industrial products excluding food and energy	28.7	1.7	-0.2	0.5	1.0
Energy	15.5	-2.0	-1.4	1.7	0.2
Services	23.7	0.7	-0.5	1.1	0.2
Core inflation indicators					
CPI excluding energy	84.5	-0.2	0.7	0.3	0.2
CPI excluding energy and unprocessed food	72.9	0.8	0.0	0.5	0.6
CPI excluding energy, food, alcohol and cigarettes	45.1	0.9	-0.4	0.9	0.3
Administered prices	18.7	1.0	0.1	-0.4	1.4

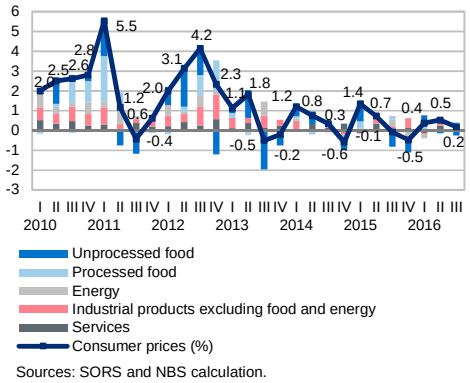
Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

pp), while fresh meat prices went up by 14.5%, hence contributing 0.6 pp to the quarterly inflation rate. The increase was driven by the jump in pork prices, which in part was seasonally induced,[2] and in part caused by the increase in world prices of pork. Still, the surge in prices of fresh pork by a total of 33.6% in July and August was followed by a 10.0% drop in September, which is earlier than usual. This has probably contributed to the increase in the price of chicken (around 20%, contribution: 0.3 pp). A moderate rise in prices of **processed food** in Q3 was prompted by the rising prices of milk and dairy products.

Though global oil prices[3] varied between USD 40 and USD 50 per barrel in Q3, the average price of oil was close to that in Q2. As a result, **petroleum product** prices in the domestic market remained almost unchanged in Q3 (increasing by 0.4%), which at the same time was the main reason behind the stagnation in **energy** prices (growth of 0.2%). In y-o-y terms, the decline in petroleum product prices slowed to 2.6% in September (from 6.7% in June) as the reduction in prices in Q2 2015 was excluded from the calculation of inflation.

Services prices practically stagnated in Q3 (growing by 0.2%), with the 3.4% increase in travel package prices providing the highest contribution to inflation (0.03 pp).

Prices of industrial products excluding food and energy were higher in Q3 (1.0%, contribution: 0.3 pp), reflecting the July increase in cigarette prices (4.7%, contribution: 0.2 pp), while the falling prices of clothes and footwear worked in the opposite direction (1.2%, contribution: -0.05 pp).

Core inflation (measured by CPI excluding prices of energy, food, alcohol and cigarettes) stood at 0.3% in Q3, mirroring the seasonal increase in the prices of textbooks and school supplies, travel packages and pharmaceuticals. In y-o-y terms, since August 2014, core inflation has been moving below the lower bound of the target tolerance band, coming at 1.6% in September.

Administered prices rose in Q3 (1.4%, contribution: 0.3 pp), reflecting an increase in cigarette prices and utility charges. However, since last year's electricity price rise was excluded from the calculation of inflation, the y-o-y growth in administered prices continued to slow down,

[2] Prices of fresh pork in the domestic market always rise during the summer months and fall towards the end of the year.

[3] Brent.

equalling 2.1% in September, principally on account of the cigarette price rise in the last twelve months (contribution: 0.5 pp).

Producer and external prices

Most producer and external prices went up in Q3, albeit mildly, hence continuing to generate relatively low cost-push pressures.

Industrial producer prices in the domestic market edged up in Q3 (0.3%). The rise was led by producer prices in exploitation of metal ores, tobacco product manufacturing and production of chemicals and chemical products. In contrast, producer prices dipped in manufacturing of paper and paper products and exploitation of crude oil and natural gas. In y-o-y terms, after falling for seven consecutive months, the growth in industrial producer prices in the domestic market entered positive territory in September and equalled 0.2% y-o-y.

Agricultural producer prices went down in July and August by a total of 5.7%. The decline was most prominent in the production of corn and wheat, industrial plants, potatoes and milk owing to an excellent agricultural season, whereas producer prices of pigs, poultry and eggs went up. Y-o-y, agricultural producer prices fell even further – by 6.0% in August.

Prices of elements and materials incorporated in construction continued up in Q3 at a slower pace than in Q2 (0.6%). In y-o-y terms, the growth in these prices entered positive territory after a year, arriving at 1.6% in September.

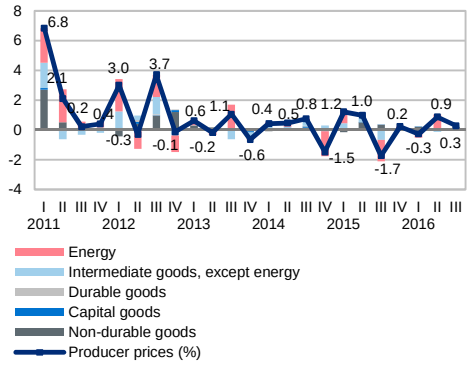
The rise in **external prices expressed in dinars**[4] continued in Q3, albeit at a slower pace than in Q2 (0.8% vs. 1.9%), reflecting the growth in world food prices measured by FAO index, particularly the prices of sugar, milk and dairy products. This growth was also affected by higher export prices of Germany, which are used to approximate external prices of equipment and intermediate goods. Other components of the external price index – global oil prices and euro area consumer prices – remained virtually unchanged compared to Q2. Similar to Q2, a mild nominal depreciation of the dinar against the euro (0.2%) had a negligible impact on the rise

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

	2015		2016	
	Sept.	Dec.	March	Sept.
Consumer prices	1.5	0.6	0.3	0.6
Domestic industrial producer prices	0.7	-1.5	-1.6	0.2
Agricultural producer prices	-2.2	-0.4	-0.4	-6.0*
Prices of elements and materials incorporated in construction	-1.6	-1.5	-1.0	1.6

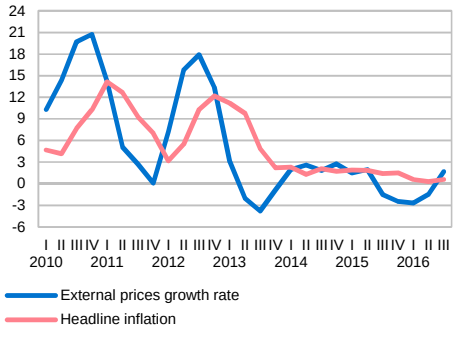
Sources: SORS and NBS calculation.
* August.

Chart III.0.4 **Contribution to quarterly producer price growth**
(in pp)



Sources: SORS and NBS calculation.

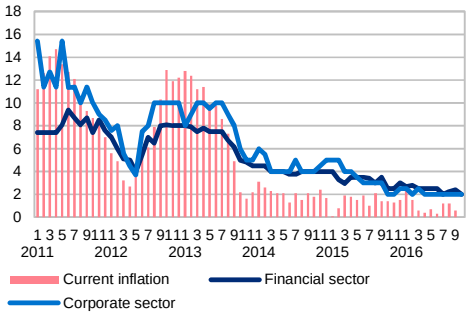
Chart III.0.5 **Domestic inflation and external prices**
(y-o-y rates, in %)



Sources: Destatis, FAO, Bloomberg and NBS calculation.

[4] The weighted average of the world oil and food price index, euro area consumer prices and export prices of Germany, one of our main trade partners, is used as an indicator of external prices.

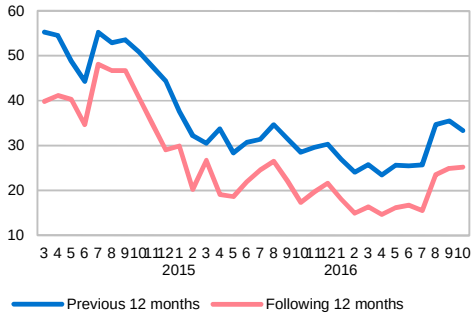
Chart III.0.6 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, in %)



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.

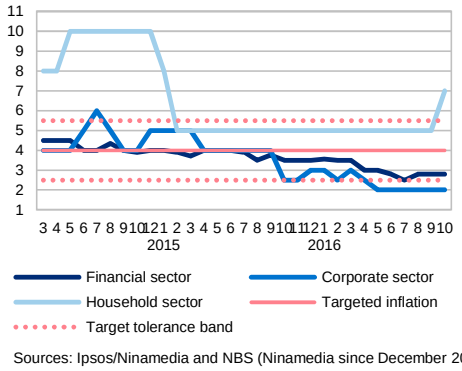
Chart III.0.7 **Household perceived and expected inflation**
(in index points)



Sources: Ipsos/Ninamedia and NBS (Ninamedia since December 2014).

* The survey was not conducted in November 2014.

Chart III.0.8 **Two-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Ipsos/Ninamedia and NBS (Ninamedia since December 2014).

* The survey was not conducted in November 2014.

of external dinar prices. In y-o-y terms, after one year, external prices returned to positive territory in Q3, growing by 1.7%.

Inflation expectations

A prolonged spell of relatively low inflation expectations indicates that economic agents expect price stability to be preserved both one-year ahead and in the medium run.

According to the **Bloomberg** survey, **one-year ahead** inflation expectations of the financial sector have been moving within the target tolerance band for over three years. The financial sector expects y-o-y inflation in August and September 2017 to equal 2.8%, and 2.7% in October 2017. The sector's one-year ahead expectations fell to 2.4% in November, following the announcement of the new inflation target for future years. The results of the **Ninamedia**[5] survey show that inflation expectations of the financial sector equalled 2.0% in October and so returned to the July level, notwithstanding their rise in August and September. Corporates' expectations have stood at 2.0% since April. In addition to weaker cost-push pressures owing to lower prices of oil and other primary commodities, it is the preserved price stability and the relative stability of the exchange rate which brought about low and stable inflation expectations of the corporate sector.

Having stayed firmly at 5.0% for nearly a year, household expectations rose to 6.0% in August and further still to 7.0% in September, where they remained in October as well. The most likely explanation for this increase lies in the fact that food and administered prices have a greater impact on household expectations than other price categories, and it was in this period that prices of fresh meat grew somewhat more than usual, attracting extensive media coverage. The rise in electricity prices as of 1 October could also have contributed to the rise in household expectations. It is likely that these price hikes have affected the results of the survey on qualitative expectations of households,[6] as both perceived and expected inflation picked up. Still, expected inflation remained below perceived inflation, which means that one part of the population, who feel that prices increased in the past 12 months, do not expect the trend to continue over the next 12 months.

[5] Ninamedia has been conducting a survey on expectations of economic agents since December 2014.

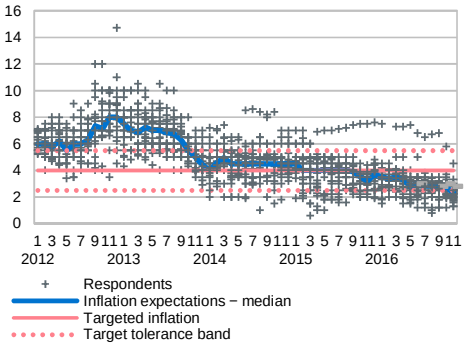
[6] For details on qualitative expectations of households, see Text box 2 of the Inflation Report – February 2016, p. 15.

The financial sector expects t**wo-year ahead inflation** to move within the target tolerance band and to equal 2.8%. Since May this year, corporates have anticipated that medium-term inflation will be 2.0%. Two-year ahead household expectations stood at 5.0% for 20 months only to rise to 7.0% in October.

The dispersion of the financial sector responses is still relatively stable and the lowest relative to other sectors, both according to the Bloomberg and Ninamedia surveys. After rising in the first two months of the year, the dispersion of corporate responses has been continuously narrowing. The dispersion of household responses rose a tad from a quarter earlier, yet was lower than last year or two years ago.

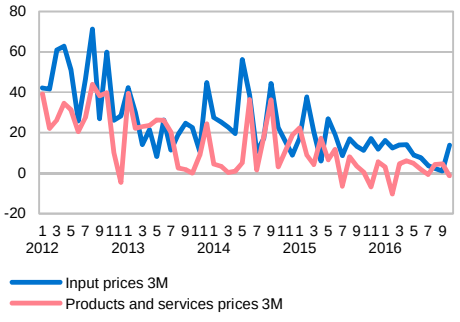
In Q3, the net percentage (NP) of enterprises expecting an increase in prices of inputs over the next three months went further down (from 7.6% to 1.0%). The NP of enterprises expecting an increase in prices of their products rose from 1.8% to 4.5%, above the NP of enterprises expecting an increase in prices of inputs. Still, despite posted growth, owing to the achieved macroeconomic stability and low inflationary pressures, both NPs are still extremely low. Moreover, in October, the NP of enterprises expecting an increase in prices of their products was negative (-1.3%), which means that the share of enterprises expecting a decline in prices of their products is greater than the number of those anticipating their increase. The majority of enterprises still do not expect a change in prices of inputs, or a change in prices of their products (81.7% and 80.6%, respectively).

Chart III.0.9 **Targeted inflation and one-year ahead inflation expectations – financial sector**
(y-o-y rates, in %)



Sources: Bloomberg and NBS.

Chart III.0.10 **Expectations of enterprises regarding a change in prices of their inputs, products and services**
(net percentage, "+" = increase, "-" = decrease)



Sources: Ipsos/Ninamedia and NBS (Ninamedia since December 2014).

IV. Inflation determinants

1. Financial market trends

Interest rates in the interbank money market were stable through Q3. This, coupled with still low interest rates in the international money market and enhanced bank competition, led to a decline in the rates on new loans (by 0.5 pp), notably those to the corporate sector. The government borrowed in the domestic securities market at even more favourable rates thanks to successful fiscal adjustment, effects of past monetary policy easing and a falling country risk premium.

Higher FDIs and further narrowing in external and internal imbalances, against the backdrop of a continued decline in the country risk premium, fuelled appreciation pressures, particularly in early Q3.

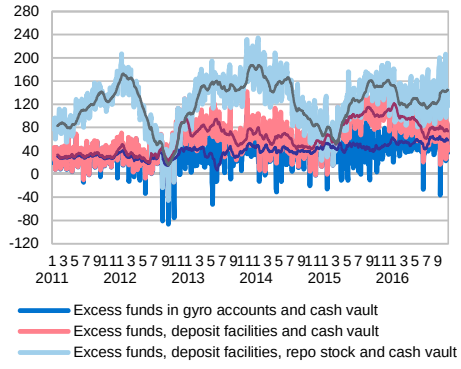
Interest rates

After the July cut in the key policy rate to 4.0% and the narrowing of the corridor of NBS interest rates vs. the key policy rate to ±1.5 pp, the spread between the average repo rate and the key policy rate was reduced. In late September, the average repo rate[7] came at 2.95%, slightly below the end-June figure (by 0.1 pp).

Rates in the interbank money market remained largely unchanged in Q3. BEONIA averaged 2.8% in September, up by 0.1 pp from June. A slight increase in BEONIA was accompanied with somewhat higher trading volumes in the interbank overnight money market which averaged RSD 4.5 bln, up by RSD 0.9 bln from Q2.

Average monthly BELIBOR rates were also up by 0.1 pp. In September, they moved between 3.0% for the shortest and 3.7% for six-month maturity.

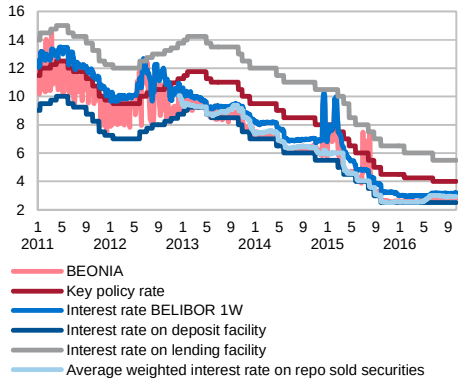
Chart IV.1.1 **Dinar liquidity**
(daily stock and 30-day moving averages, in RSD bln)



Source: NBS.

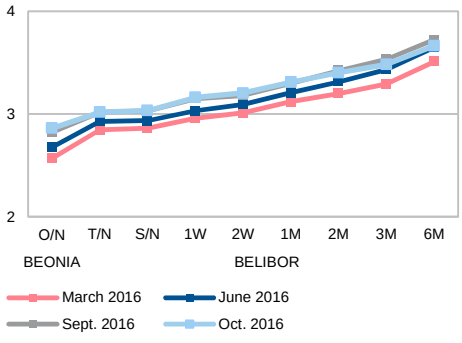
[7] Rate achieved at repo auctions weighted by the amount of sold securities.

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



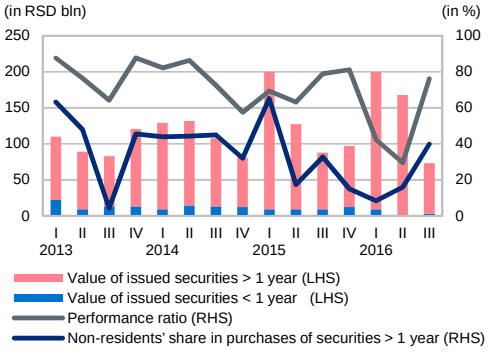
Sources: Thomson Reuters and NBS.

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



Sources: Thomson Reuters and NBS.

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



Source: Ministry of Finance.

October saw a moderate increase in trading volumes in the interbank money market, while interest rates stayed broadly flat relative to September.

A significant improvement in the fiscal position and the consequently reduced government's need to borrow, along with past monetary policy easing, spurred a further fall in interest rates on dinar government securities in Q3. Rates on one- and three-year securities fell by 0.4 pp to 3.6% and 5.0% respectively, while the rate on six-month securities (2.7%) was by 0.6 pp lower relative to March. An auction of seven-year dinar securities was held in July – the government borrowed at a 5.98% rate, down by 4.8 pp relative to the rate recorded at the previous auction in March 2015. Non-resident participation was significant, owing not only to longer-maturity securities, but also exceptionally positive IMF's assessment of the implementation of the arrangement and the upgrade in the country's credit rating by Fitch.

High non-resident participation was also recorded at the October auction of seven-year dinar securities. The rates at this and at the auction of three-year securities declined further.

The rates at auctions of government euro securities also declined in Q3. The rates on one- and two-year securities fell by 0.1 pp to 0.8% and 1.1% respectively, and the rate on five-year securities (2.9%) lost 0.5 pp compared to the previous, same-maturity auction of March.

Total trading volumes in the secondary market of government securities amounted to RSD 80.6 bln, down by RSD 50.6 bln compared to Q2. This was due also to significantly reduced activity of non-residents on the sale side relative to Q2. Most traded were securities of the original maturity of three and seven years. The rates of return on most securities declined, ranging in September from 3.4% for the remaining four-month to 5.8% for the remaining 82-month maturity.

Past monetary policy easing, low interest rates in the euro area and enhanced bank competition reflected on lower rates on new loans, notably those to the corporate sector. The weighted average rate on dinar corporate and household loans fell by 0.5 pp to 8.7% in Q3. The decline was driven by cheaper corporate loans, with the weighted average rate down by 0.6 pp to 6.0% in September. The steepest fall was recorded for rates on investment loans (by 1.9 pp to 5.8%) – as a result, these rates were equal with those on current assets loans. Rates on other loans also declined, to 6.5%.

The weighted average rate on dinar household loans was up by 0.8 pp to 11.3% in September, reflecting primarily an increase in the rates on cash loans (including refinancing loans) by 1.0 pp to 11.7% in September. Apartment refurbishment loans and other loans were also approved at higher rates (7.4% and 9.7% respectively). In contrast, the price of consumer loans was down by 0.5 pp to 9.4%.

The weighted average rate on new euro and dinar euro-indexed corporate and household loans declined further in Q3, by 0.2 pp to 3.5% in September. The average rate on corporate loans fell by the same amount, to 3.3% in September. The decline was the most pronounced for euro-indexed investment loans (by 0.3 pp to 3.6%). The rates on current assets and other loans went down as well (to 3.2% and 3.5% respectively). A 0.1 pp decline in the average rate on household loans (4.6% in September) was led by falling rates on housing loans (by 0.2 pp to 3.3% in September) and other loans (by 1.0 pp to 6.4%). Consumer loans were approved at the same rate as at end-Q2 (5.7%). It was only the price of cash loans (3.8%) that picked up from June.

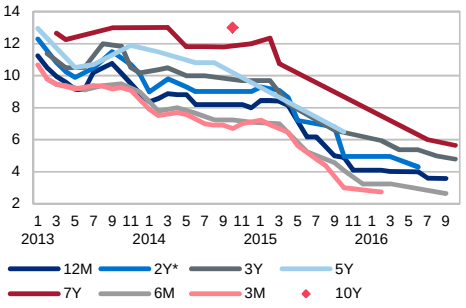
Rates on dinar household deposits declined somewhat in Q3 (by 0.2 pp) and reached 3.1% in September. The rates on corporate deposits went up by the same amount, to 2.6%. The rate on household FX savings fell by 0.2 pp to 0.5%, while the rate on new corporate deposits stayed at around 0.5%.

Risk premium

Serbia's risk premium continued down. Measured by EMBI, it lost 59 bp in Q3, and fell to 225 bp. On 22 September it dropped further down, to 212 bp, its lowest level in nine years. Q3 also saw a reduction in EMBI Global (by 47 bp) and in the risk premia across the region, with the exception of Turkey.

Serbia's risk premium, i.e. the difference in yields on Serbia's dollar eurobonds and US treasury securities, declined thanks to both global and domestic factors. In terms of global factors, it was reduced owing to the relatively quick stabilisation of the international financial market after Brexit. It turned out that the short- term negative effects of Brexit were weaker than expected, though medium- and long-term effects are still unknown. Markets were appeased relatively quickly by the investors' expectations that Brexit will drive leading central banks to pursue more accommodative monetary policies than previously expected.

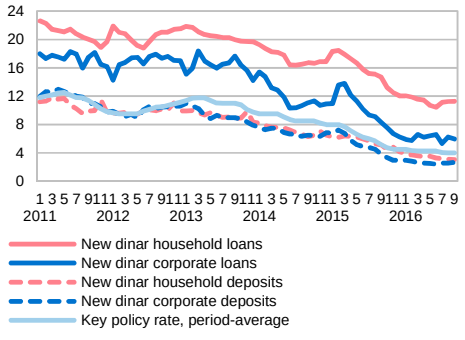
Chart IV.1.5. **Interest rates in the primary market of government securities**
(p.a., in %)



Source: Ministry of Finance.

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

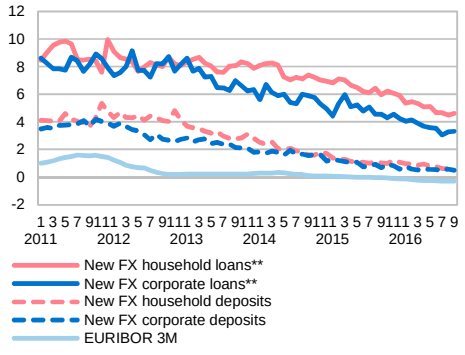
Chart IV.1.6 **Interest rates on dinar loans and deposits of corporates and households***
(weighted average values, p.a., in %)



Source: NBS.

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

Chart IV.1.7 **Interest rates on FX loans and deposits of corporates and households***
(weighted average values, p.a., in %)

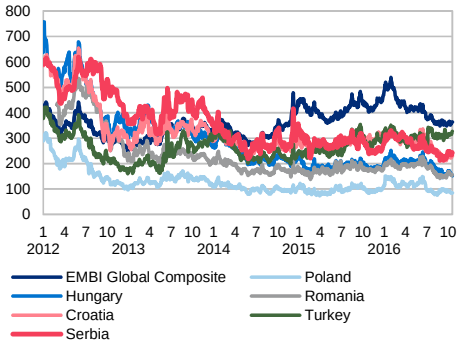


Sources: European Banking Federation and NBS.

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

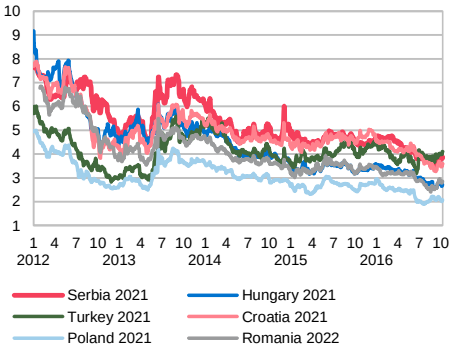
** Euro and euro-indexed.

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



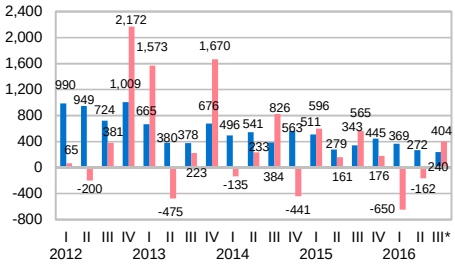
Source: JP Morgan.

Chart IV.1.9 **Yields on eurobonds of countries in the region**
(in %)



Source: Bloomberg.

Chart IV.1.10 **Current account deficit and net capital inflow**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

Domestic factors were also behind the reduction in Serbia's risk premium in the observed period – most notably the further narrowing of internal and external imbalances, aided by consistent implementation of fiscal consolidation measures and structural reforms. Better macroeconomic performance of the Serbian economy and its improved prospects for the period ahead were acknowledged by the IMF as well, which completed the fourth and fifth reviews under the precautionary Stand-By Arrangement. The IMF judged that the extent of Serbia's economic recovery exceeded expectations. The recovery was supported primarily by efforts to strengthen public finance, advance structural reforms and boost investment confidence.

An increase has been recorded in risk premia of emerging economies in October, though they are still considerably lower than in early 2016. The increase in risk premia resulted from uncertainties in the international financial market over the pace of normalisation of the Fed's monetary policy and the continuation of the ECB's asset purchase programme. In October, Serbia's risk premium increased by 18 bp to 243 bp.

Foreign capital inflow

Foreign trade imbalance continued narrowing in Q3, and the financial account recorded an inflow that was more than sufficient to cover the current account deficit, adding to appreciation pressures on the dinar during the period. As before, most of the capital inflow in Q3 was in the form of FDI, while an inflow was also registered in respect of portfolio investment. A small capital outflow was posted in respect of financial loans.

In Q3, net **FDI** inflow was higher than a quarter earlier, and according to the preliminary data, it equalled EUR 437.7 mln, reaching EUR 1,265.7 mln since the start of the year. As a year earlier, investments were diversified across a wide variety of projects in different industries. The largest amounts were directed towards manufacturing, financial sector, construction, trade, real estate activities, telecommunications and transport.

The successful implementation of fiscal consolidation and structural reforms, and the achievement of macroeconomic stability helped improve investment ambience in Serbia. This improvement is confirmed by the trends recorded in the year so far, and the net FDI inflow in 2016 is likely to exceed our previous expectations, and just like a year before, reach around

EUR 1.8 bln or 5% of GDP.[8] Such an inflow will be more than sufficient to cover the current account deficit, estimated at 4.1% of GDP for this year.

A net capital inflow in respect of **portfolio investment** (EUR 10.3 mln) in Q3 resulted primarily from non-residents' purchase of seven-year government securities at the July auction. Higher exposure toward emerging economies in Q3 may be linked to non-residents' expectations that leading central banks would pursue accommodative monetary policies longer than expected. In the case of Serbia, it may also be associated with more favourable macroeconomic prospects, positive reviews of the IMF regarding the arrangement implementation, and raised credit rating. On the other hand, in Q3, residents increased their investment in foreign securities (EUR 9.5 mln).

Net outflow arising from **financial loans** equalled EUR 12.0 mln. Liabilities of enterprises under cross-border loans increased by EUR 80.5 mln. On the other hand, the government net repaid EUR 15.7 mln — EUR 200.2 mln related to loan repayment, while the largest amounts under loans disbursed (EUR 184.5 mln), related to loans intended for construction and reconstruction of road infrastructure. The scale of bank deleveraging was more modest than in the previous two quarters (EUR 48.2 mln).

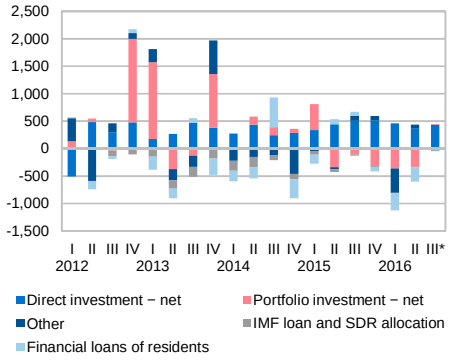
Trends in the FX market and exchange rate

The dinar exchange rate was stable both in Q3 and in October. At the end of the period, the value of the dinar vis-à-vis the euro was almost unchanged compared to end-Q2. Although appreciation pressures were felt during the review period, primarily in July, they were eased by NBS interventions on the FX purchase side.

As the dinar exchange rate against the euro stayed almost unchanged and the euro strengthened against the dollar, Q3 also saw the dinar rise versus the dollar (1.1%, end-period).

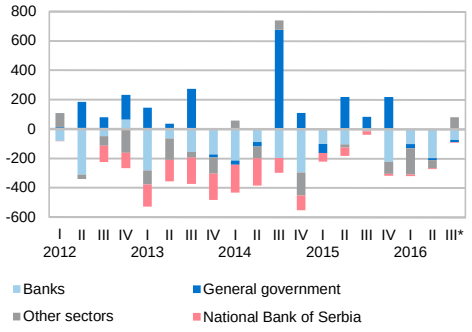
Appreciation pressures on the dinar in the review period came primarily from a significant improvement in the country's macroeconomic indicators, positive reviews of the IMF regarding the programme implementation, raised credit rating by Fitch and the resulting stronger confidence of investors in dinar government securities. Also, appreciation pressures can be ascribed to a drop in

Chart IV.1.11 **Structure of the financial account**
(in EUR mln)



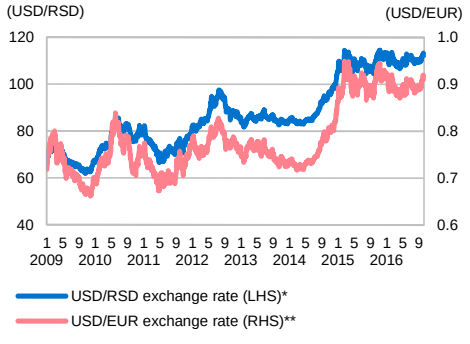
Sources: SORS and NBS.
* Preliminary data.

Chart IV.1.12 **Financial loans of residents – change in net borrowing**
(in EUR mln)



Source: NBS.
* Preliminary data.

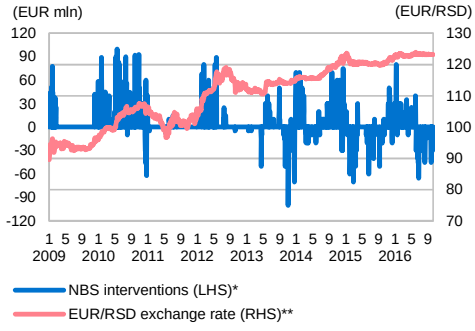
Chart IV.1.13 **Movements in RSD/USD and EUR/USD exchange rates**



Source: NBS.
* 1 USD in RSD.
** 1 USD in EUR.

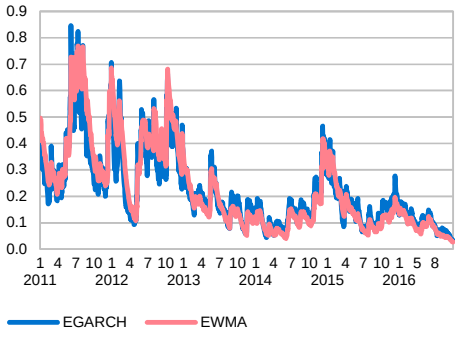
[8] Our FDI projections do not include potential inflow from privatisation.

Chart IV.1.14 **Movements in EUR/RSD exchange rate and NBS FX interventions**



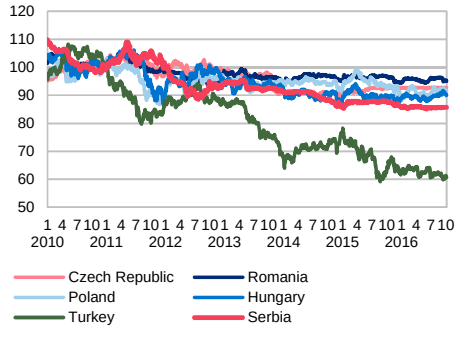
Source: NBS.
* + sale; - purchase.
** 1 EUR in RSD.

Chart IV.1.15 **Short-term volatility of the RSD/EUR exchange rate**
(in %)



Source: NBS.

Chart IV.1.16 **Movements in exchange rates of national currencies against the euro***
(daily data, 31 December 2010 = 100)



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

Serbia's risk premium following Brexit and foreign investors' improved sentiment towards emerging economies owing to expectations that monetary policy measures of leading central banks would stay accommodative for longer than previously anticipated.

Consequently, the domestic FX market saw heightened foreign investor demand for dinars in July, for the purpose of investing in dinar government securities. This was the first month since March 2015 in which non-residents acted as net sellers of foreign currency to banks. At the same time, FX demand of domestic enterprises was lower than usual. In July, they net purchased EUR 38.8 mln compared to over EUR 200.0 mln, which is the average level of their monthly net purchases. Similar trends (lower demand of domestic enterprises for foreign exchange and higher demand of non-residents for dinars) prevailed in October.

These flows were sufficient to neutralise somewhat lower purchase of foreign cash in Q3 compared to a quarter earlier. In addition, FX inflow under exports and FDI stayed broadly unchanged at its high Q2 level.

To ease excessive short-term volatility of the exchange rate, in Q3, the NBS intervened in the IFEM by buying EUR 475.0 mln, most of which in July (EUR 355.0 mln). In October it also intervened on the purchase side, buying EUR 135.0 mln.

In Q3, daily trading volumes in the IFEM averaged EUR 18.8 mln, down by EUR 6.6 mln from Q2.[9] The highest average daily amounts were recorded in July (EUR 27.0 mln). The comparable figure in September is EUR 13.9 mln. Volatility of the dinar exchange rate against the euro, as measured by EWMA[10] and EGARCH,[11] stayed low.

The volume of swap transactions at regular FX swap auctions organised by the NBS in Q3 was higher than in the quarter before. The NBS bought and sold EUR 45.0 mln at three-month auctions and EUR 114.0 mln at two-week auctions each. The amount of interbank FX swaps in Q3 equalled EUR 9.7 mln, and these were recorded in July.

Stock exchange trends

Higher share prices helped the recovery of indices on the Belgrade Stock Exchange (BSE) in Q3. End-September,

[9] Excluding the NBS..
[10] EWMA – Exponentially Weighted Moving Average.
[11] EGARCH – *Exponential General Autoregressive Conditional Heteroskedasticity.*

BELEX15 equalled 636.3 and BELEXline 1,439.0 points, up by 5.2% and 8.5% from end-June, respectively. These indices continued up in October as well. Most stock exchange indices in the region also grew in Q3. The growth of indices was the strongest on the Zagreb (15.8%) and Skopje (14.5%) stock exchanges. On the other hand, only the Banja Luka stock exchange index declined (by 4.5%).

Trading in shares went further down during the summer months. Total turnover came at RSD 1.0 bln in Q3, down by RSD 0.4 bln from a quarter earlier. The highest trading volumes were recorded in July (RSD 0.4 bln), while two-thirds of trading related to shares from the BELEX15 index basket. Foreign investor participation in stock trading amounted to RSD 0.4 bln. As investors were more active on the sale side during the entire period, they sold RSD 98.1 mln net at the quarterly level.

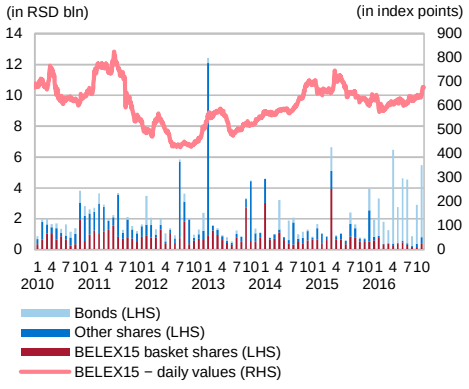
As in the previous two quarters, the majority of stock exchange trading related to trading in bonds. Total trading in bonds equalled RSD 7.3 bln in Q3, fully owing to trading in long-term RS bonds,[12] whereby transactions with foreign investors accounted for around one quarter of the trading. No trading in municipal bonds was recorded in this quarter either.

BSE market capitalisation equalled RSD 585.5 bln at end-September, down by RSD 61.2 bln from end-June owing, among other, to the departure or withdrawal of some issuers from the stock exchange despite the increase in share prices. Regulated market capitalisation contracted by RSD 25.5 bln, while MTP[13] capitalisation fell by RSD 35.7 bln. This led to the reduction in the share of market capitalisation in estimated GDP by 1.6 pp to 14.4% at end-Q3.

2. Money and loans

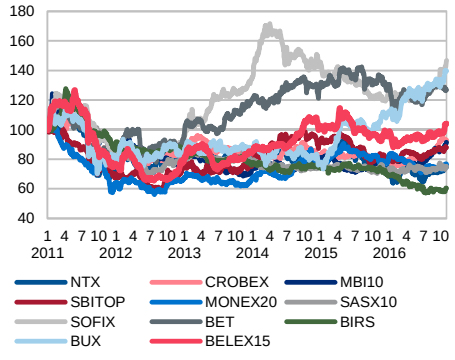
The money supply increased further in Q3, with its dinar and foreign currency components rising almost equally. The maturity structure of dinar deposits continued to change in favour of demand deposits. Growth in lending activity continued, accelerating in y-o-y terms on the back of past monetary policy easing, low international money market rates, increased competition among banks and faster economic activity.

Chart IV.1.17 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

Chart IV.1.18 **Stock exchange indices across the region**
(in index points, normalised, 31 December 2010 = 100)



Sources: BSE and websites of regional stock exchanges.

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

	2015	2016			Share in M3
	Dec.	March	June	Sept.	Sept. 2016 (%)
M3	5.0	6.6	8.7	10.8	100.0
FX deposits	1.1	3.6	5.8	9.0	65.2
M2	12.7	13.1	14.8	14.3	34.8
Time and savings dinar deposits	6.6	-9.5	-3.5	-4.9	8.2
M1	15.4	22.8	22.1	21.9	26.7
Demand deposit	19.6	26.3	24.8	24.7	19.7
Currency in circulation	5.6	14.2	15.1	14.6	6.9

Source: NBS.

[12] In November 2015, trading in government long-term bonds on the BSE was enabled.

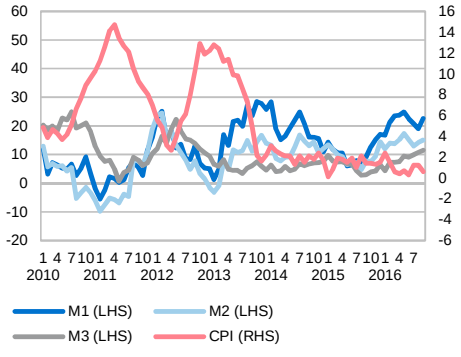
[13] MTP is the multilateral trading platform, set up by the Belgrade Stock Exchange and incorporating currently listed shares of companies not eligible for regulated market listing.

Monetary aggregates

In Q3, dinar reserve money lost 2.5% in nominal and 2.7% in real terms. Total reserve money decreased by the same amount, due to the drop in dinar reserve money, but also to somewhat lower FX deposits of banks with the NBS. In y-o-y terms, the real decrease in reserve money slowed down to 5.5% for dinar reserve money and 10.2% for total reserve money.

Excellent results of fiscal consolidation and rising budget revenues[14] drove government dinar deposits up by RSD 32.3 bln in Q3, even though a significant part of the dinar funds was used to buy FX from the NBS. In this way, the government contributed RSD 50.3 bln to reserve money withdrawal in Q3. Higher bank investment in repo securities worked in the same direction (contributing RSD 36.8 bln). On the other hand, banks' dinar liquidity expanded chiefly owing to NBS FX purchases in the IFEM (RSD 56.1 bln) and FX payment transactions with Kosovo and Metohija (RSD 14.4 bln).

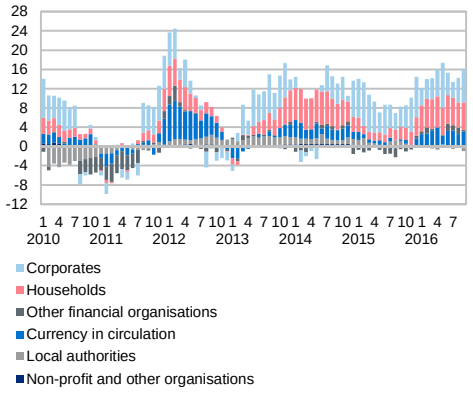
Chart IV.2.1 **Monetary aggregates and CPI**
(y-o-y rates, in %)



Sources: SORS and NBS.

Unlike reserve money, broader monetary aggregates continued up in Q3. As before, growth in dinar deposits with shorter maturities was more pronounced, with M1 and M2 gaining 6.7% and 5.9%, respectively, in real terms. Together with the rise in FX deposits, this led to a 2.9% increase in M3 in real terms.

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



Source: NBS.

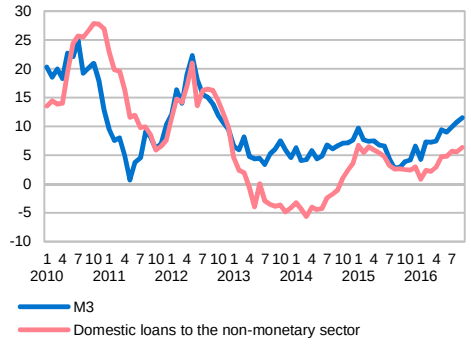
Demand deposits grew by RSD 28.3 bln in Q3, while savings and term deposits expanded by RSD 6.3 bln. Growth has been stronger in dinar deposits with shorter maturities for an extended period of time, which can be linked to the recovery of economic activity, and, to an extent, the curbing of the grey economy. An increase in both deposits with shorter and longer maturities was primarily recorded in corporate and household accounts. Owing to a widely dispersed recovery of economic activity, deposits increased in accounts of companies belonging to almost all industries and particularly those of manufacturing companies. Household dinar savings reached a new peak in September – RSD 49.0 bln, which is RSD 1.3 bln higher than at end-June and RSD 3.6 bln higher than at end-2015. An extended period of low and stable inflation, relative stability of the exchange rate, higher interest rates and preferential tax treatment of dinar

[14] Collection of public revenues increased further in Q3, which, amid stable budget expenditures, contributed to the general government budget deficit of RSD 4.5 bln in the first nine months. The improvement in the country's fiscal position is also confirmed by the fact that the quantitative performance targets agreed under the arrangement with the IMF (fourth and fifth review) permitted an RSD 81.3 bln deficit in the first nine months.

relative to FX savings encouraged an increase in dinar household savings. FX household savings increased as well, by EUR 47.7 mln to over EUR 8.5 bln in September. FX deposits of the majority of other sectors also rose, most notably deposits of corporates, which increased by an additional EUR 153.2 mln as a result of good export performance.

Y-o-y, the growth in the dinar money supply in September (M1 by 21.9% and M2 by 14.3%) was close to that recorded in June, while M3 accelerated further up, to 10.8%. It is quite certain that economic recovery also gave a strong impulse to this increase.

Chart IV.2.3 **Domestic loans to the non-monetary sector and M3**
(nominal y-o-y rates, in %)



Source: NBS.

Loans

Domestic loan growth accelerated further in Q3, reaching 4.3% y-o-y in September, excluding the exchange rate effect.[15] Household loans rose by 9.1% and corporate loans by 1.1% from the same period last year.

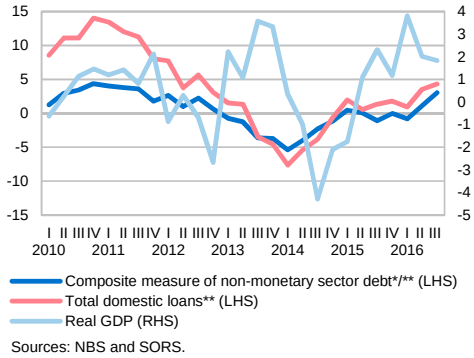
Excluding the exchange rate effect, domestic loans increased by 2.0% in Q3, and their share in estimated GDP – to 49.1%. The increase was recorded at a time when banks, as part of their efforts to resolve the issue of NPLs, continued writing-off NPLs and selling a part of these loans to entities outside the banking sector.

Looking forward, lending activity is expected to recover further in the coming period, given the acceleration in economic activity in 2016 and 2017 and the notable reduction in lending rates thanks to past monetary policy easing of the NBS, low international money market rates and interbank competition.

Corporate loans gained 1.3% or RSD 13.9 bln in Q3, excluding the exchange rate effect. The negative impact of the maturing of subsidised loans on the stock of loan receivables wore off entirely, as the last loans extended under this programme came due for payment in late Q2. At the same time, the use of dinar loans went up.

The recovery is also indicated by the total amount of new corporate loans in Q3 (RSD 229.4 bln), which rose by 14% y-o-y. Around 23% of this amount related to loans

Chart IV.2.4 **Lending activity and GDP**
(y-o-y rates, in %)



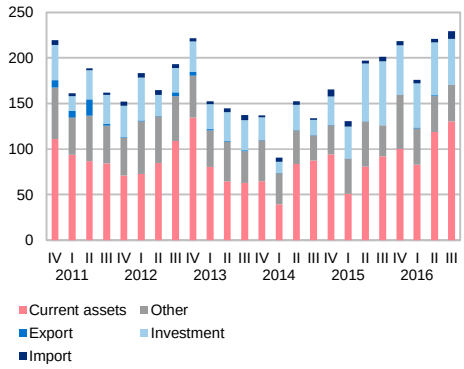
Sources: NBS and SORS.

* 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.

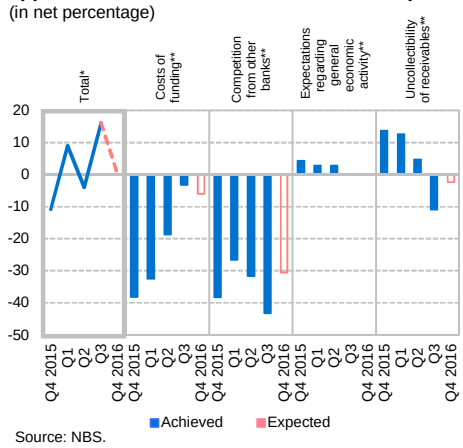
[15] Calculated at the dinar exchange rate against the euro, Swiss franc and US dollar as at 30 September 2014 (the so-called programme exchange rate used for the purpose of monitoring the IMF arrangement), according to the currency composition of loan receivables.

Chart IV.2.5 **Structure of new corporate loans**
(in RSD bln)



Source: NBS.

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

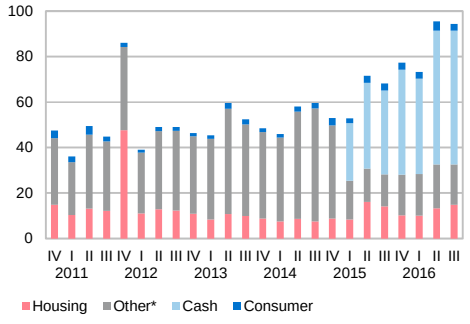


Source: NBS.

* 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.2.7 **Structure of new household loans**
(in RSD bln)



Source: NBS.

* Until December 2014, the 'Other loans' category included both cash and other loans.

refinanced with the same bank. From the start of the year, a total of RSD 626.2 bln worth of new corporate loans were approved, up by 18.3% from the same period last year. As corporate loan demand continued to be driven largely by the need to finance current assets and restructure debts, current assets loans accounted for over a half of new corporate loans (around 52%). Investment loans kept their relatively high share in new loans (around 25%), signalling increased reliance on loans for investment financing. Thanks to a recovery in investment lending, this loan category made up over a third (33.6% in September) of corporate loan receivables. Loans with the original maturity of over two years accounted for around 65% of corporate loan receivables in September.

According to the results of the October bank lending survey,[16] terms of borrowing were more favourable for corporates in Q3 due to lower margins, associated costs and interbank competition, while the requirements regarding collateral and maximum loan amount were tightened. On the other hand, corporate demand for loans continued rising, guided by the need to finance current assets and restructure debt. These two factors, coupled with investment financing, should be the key drivers of growth in corporate demand, which is expected to continue in Q4. Banks expect standards to remain unchanged in Q4.

The robust growth in household loans continued in Q3. They gained 3.0% or RSD 22.6 bln, excluding the exchange rate effect. This rise was driven primarily by a higher volume of cash loan approvals (including refinancing loans).

The volume of new household loans in Q3 (RSD 94.4 bln) was by 38.4% higher than in the same period last year. A similar increase was recorded for the total amount of new loans in the first nine months of 2016 (RSD 263.2 bln) vis-à-vis the same period in 2015. Cash loans made up 62.3% of new household loans and were almost entirely dinar denominated (over 99%); of this, around 70% were loans with a repayment period of over five years. Helped by lower interest rates on housing loans and more favourable real estate market conditions regarding both the supply and prices of flats, the volume of new housing loans rose in Q3, making up around 16% of new household loans. Banks started offering dinar housing loans with a repayment period of up to 30 years and an

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

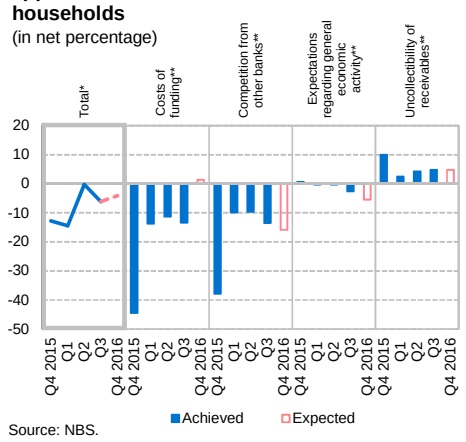
interest rate below 5%, which is another confirmation of the achieved monetary policy results and macroeconomic stability. Borrowing under more expensive loan categories, credit cards and current account overdrafts, stayed close to its Q2 level.

According to the results of the October bank lending survey, banks further eased their credit standards for households. This trend is expected to continue in Q4. The easing of standards resulted primarily from cheaper sources of funding and interbank competition, but also from positive expectations regarding economic activity growth and greater risk propensity. Interest rate margins and associated costs were trimmed further, and households were offered more favourable terms of repayment. Consistent with the banks' expectations, household demand continued rising. Dinar cash and refinancing loans, as well as FX-indexed housing loans, were in highest demand. Increased demand was driven primarily by real estate purchases and the need to refinance current obligations. These factors are expected to stay the key drivers of demand growth in the coming period.

Dinarisation increased further in Q3. At end-September, 31.4% of corporate and household loans were denominated in dinars, up by 2.7 pp from end-2015. As households increasingly borrowed in dinars, over 75% of new household loans in Q3 were denominated in dinars. This led to a further rise in the dinarisation of household loans, by 3.5 pp from the start of the year to 46.3% in September. New corporate loans in dinars also increased (25% on average in Q3) which, together with the exhaustion of the negative effect of the maturing of subsidised loans, pushed up the dinarisation of corporate loans. The share of dinar in total corporate loans equalled 20.7% in September, rising by 1.4 pp from end-2015.

The implementation of the NPL Resolution Strategy continues to yield results. The share of NPLs in total loans, on a gross basis, decreased further to 19.5% in September, down by 2.1 pp from December 2015. The share of NPLs decreased by 3.0 pp to 18.7% in the corporate[17] and by 0.9 pp to 10.0% in the household sector.[18] On the one hand, the NPL share decreased as a result of collection, restructuring, write-off and sale of a part of NPLs and, on the other, due to an increase in new lending.

Chart IV.2.8 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to households**
(in net percentage)

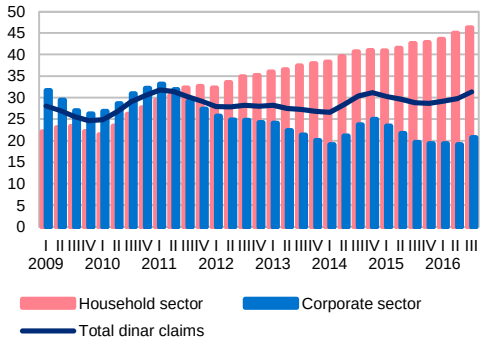


Source: NBS.

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

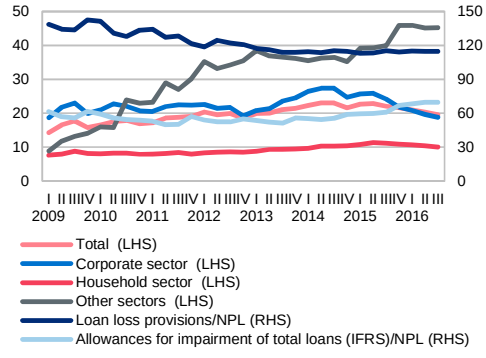
** Positive values indicate the contribution of individual factors to tightening, and negative values indicate the contribution to easing of credit standards.

Chart IV.2.9 **Share of dinar in total bank claims from corporate and household sectors**
(in %)



Source: NBS.

Chart IV.2.10 **NPL share in total loans, gross principle**
(in %)



Source: NBS.

[17] Includes companies and public enterprises. If only companies are observed, the share of NPLs in total loans came at 19.7% in September, down by 3.9 pp from end-2015.

[18] With entrepreneurs and private households included, the share fell by 1.0 pp to 10.7%.

Despite the relatively high share of NPLs in total loans, the capital adequacy ratio of 21.2% indicates that the domestic banking sector is highly capitalised. In September, total allowances for loan impairment came at 69.5% of NPLs (8.8 pp more than a year earlier), while loan loss provisions,[19] at 114.5% in September, continued to fully cover the amount of gross NPLs.

3. Real estate market

Gradual recovery of the real estate market extended into Q3, as lower real estate prices and lower cost of credit gave a boost to housing loan demand and real estate turnover.

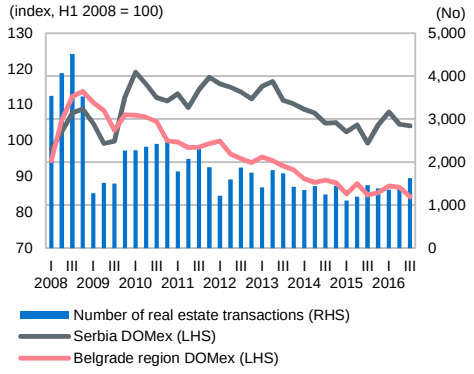
Serbia's average real estate prices, as measured by DOMex,[20] recorded a mild quarterly decline (0.4%), largely reflecting a fall in Belgrade real estate prices (3.1%). On the other hand, real estate prices went up in southern and eastern Serbia, while stagnating in Vojvodina, Šumadija and western Serbia. Y-o-y, DOMex continued up in Q3 (4.9%) and was higher on average by 3.4% in the first three quarters compared to the same period last year.

The fall in Belgrade real estate prices worked to reduce regional disparities, so the average price of real estate in Belgrade in Q3 was 68% above the Serbian average (vs. 76% in Q2). In Q3, the average real estate price in Serbia was EUR 863.4 per square meter.

In part reflecting the price decline, the number of real estate sales[21] continued up, reaching a three-year high in Q3, with increases recorded across all of the regions observed. The Belgrade region still accounts for around one half of real estate transactions, Vojvodina for one fourth, while Šumadija, western, southern and eastern Serbia account for the remaining 25–30%. Real estate transactions were on a constant rise since early 2016 – in the first three quarters they were 17.5% higher y-o-y, which may indicate gradual recovery in the real estate market.

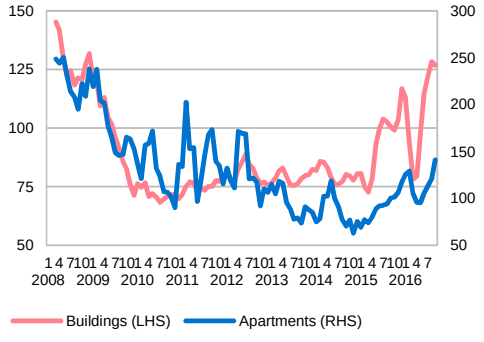
In addition to lower prices, demand in the real estate market was also driven up by lower rates on new housing

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**
(3M averages s-a, 2015 = 100)



Sources: SORS and NBS calculation.

[19] Loan loss provisions are not an accounting category, meaning they are not recorded in the income statement but only serve for the calculation of 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).

[20] The DOMex is published by the National Mortgage Insurance Corporation and relates only to real estate purchased by insured loans.

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

loans, which declined further in Q3. This is confirmed also by the bank lending survey, which signals higher demand for new housing loans, while at the same time credit conditions were eased.

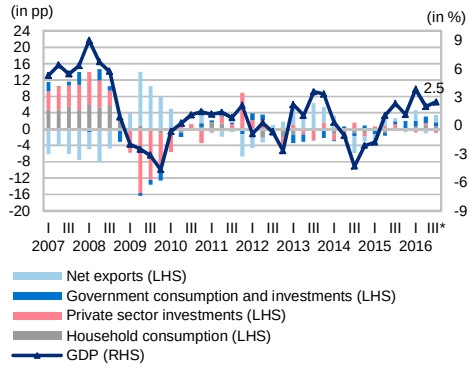
Following vigorous growth in Q1, the number of newly built apartments declined in Q2. Thus on the overall, the supply in this segment of the real estate market stagnated in y-o-y terms in H1. Supply is expected to increase in the coming period given that the number of construction permits issued in July and August rose by 15.2% y-o-y for buildings, and by 26.7% y-o-y for apartments.

4. Aggregate demand

After stagnating in Q2, GDP rose by 0.5% s-a in Q3, largely driven by investment. A further positive boost came from net exports. In contrast, after four consecutive quarters of growth, household consumption stayed flat in Q3. According to the preliminary estimate of the Serbian Statistical Office, GDP growth accelerated to 2.5% y-o-y in Q3.

Owing to faster than expected recovery of final consumption, GDP growth projection for 2016 was revised upwards for the third time this year, and the latest NBS forecast puts it at 2.7%.

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



Sources: SORS and NBS calculation.
* NBS estimate.

Domestic demand

Private investment rose by 0.7% s-a in Q3, adding further 0.1 pp to GDP growth. Investment growth is indicated primarily by the construction indicators – in Q3, the value of works performed increased by 1.8% s-a, the number of construction permits continued to grow (7.6% s-a), and employment in the construction sector also went up. At the same time, production of construction material stagnated relative to Q2. As regards investment in equipment, domestic production of machinery and equipment expanded in Q3 (10.3% s-a), while imports of equipment declined (3.1% s-a). Given that a large portion of imported goods are still non-classified, equipment imports could record growth after the reclassification.

Investment growth was supported by the improvement of the business and investment climate, as confirmed by Serbia's progress on the latest World Bank's Doing Business 2017 list. Serbia qualified among the ten countries with greatest improvement in business conditions and rose from the 54th to the 47th position. This was largely due to the introduction of electronic construction permits, which considerably improved the

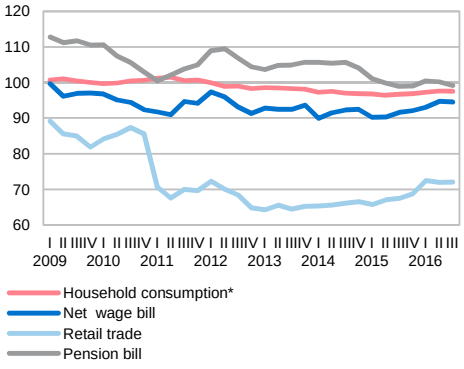
Table IV.4.1 **Investment indicators**

	2015		2016		
	III	IV	I	II	III
Real indicators (seasonally-adjusted, quarterly growth, in %)					
Industrial inventories	-1.1	-2.4	1.1	0.7	6.1
Industrial production of capital goods	-8.6	6.0	5.0	-2.0	-3.7
Exports of equipment*	3.6	4.4	25.9	-1.9	4.2
Imports of equipment*	0.5	0.4	-3.4	-1.7	-3.1
Inventories of capital goods	-5.2	3.1	5.7	1.5	3.4
Industrial production of intermediate goods	1.0	1.0	4.1	4.9	-1.7
Exports of intermediate goods*	3.1	3.0	3.2	4.0	2.1
Imports of intermediate goods*	1.3	5.2	-4.0	2.2	-0.6
Inventories of intermediate goods	-2.3	2.3	2.9	2.4	8.8
Industrial production of construction materials	6.7	2.7	1.8	0.3	0.4
Inventories of construction materials	-2.1	1.0	2.5	1.4	0.4
Government investment**	4.0	4.2	4.3	4.2	4.0

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

country's ranking in this segment. Marked progress was evident also in the areas of starting a business and registering property, i.e. areas that are also important for attracting new investment.

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



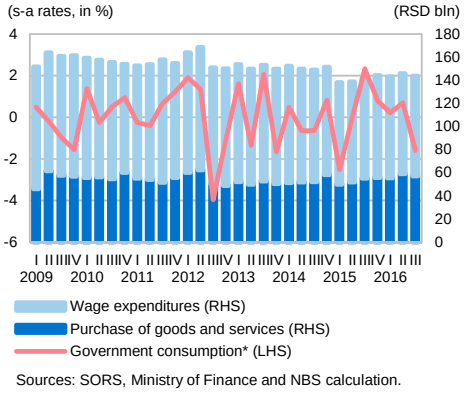
Sources: SORS and NBS calculation.
* NBS estimate for Q3 2016.

The above trends should boost the FDI inflow, which in Q3 rose above the Q2 level, while flatlining y-o-y in the first nine months of 2016. In addition, positive effects of low operating costs, stemming from the low price of oil and reduced interest expenses on investment loans, coupled with the continuous improvement of economic growth prospects, are likely to encourage our companies to embark on new investment.

Among components of domestic demand, the greatest positive boost in Q3 is estimated to have come from a change in inventories (0.2 pp). To some extent this was expected given that agricultural inventories, which increased this year on the back of an above-average agricultural season, are in major part stocked up in Q3. Industrial inventories also went up (6.1% s-a), mainly in food and chemical industries and base metals production. On the other hand, the planned overhaul in the Pančevo refinery and the discontinuation of production in September depressed inventories of petroleum products (10.8% s-a).

Following four quarters of uninterrupted growth, **household consumption** is estimated to have stagnated in Q3. This is signalled by divergent movements of key consumption indicators. As retail trade stagnated, the number of tourist arrivals and overnight stays rose by 3.9% and 4.2% s-a respectively, while the imports of consumer goods dropped by 2.7% s-a. Y-o-y, household consumption continued up (0.9%), giving a 0.7 pp positive contribution to GDP.

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



Sources: SORS, Ministry of Finance and NBS calculation.
* NBS estimate for Q3 2016.

Stagnation of household consumption is indicated also by the movement of its main sources in Q3. The real net wage bill inched down mildly (0.2% s-a), while social insurance transfers remained at a similar level as in Q2. The inflow of remittances was also somewhat lower than in Q2. On the other hand, consumption lending by banks gained an even stronger momentum in Q3.

Having trended upwards four quarters in a row, final **government consumption** dropped in Q3 (1.6% s-a), giving a negative 0.3 pp contribution to GDP. This was in part the result of further shrinking of public sector wage expenditures, which is in line with the planned rightsizing of the public sector. Also, compared to the quarter before, Q3 saw lower expenditures for goods and services. Y-o-y, this demand component continued up (1.4%), giving a 0.2 pp contribution to GDP.

Government investment also remained on an upward path, rising by 4.0% s-a in Q3 and adding 0.1 pp to GDP. This is indicated by the movement in consolidated government capital expenditures for infrastructure projects, which create conditions for sustainable GDP growth in both the medium- and long-term. High growth of government investment continued y-o-y as well (26.5%), giving a positive 0.8 pp contribution to GDP.

Net external demand

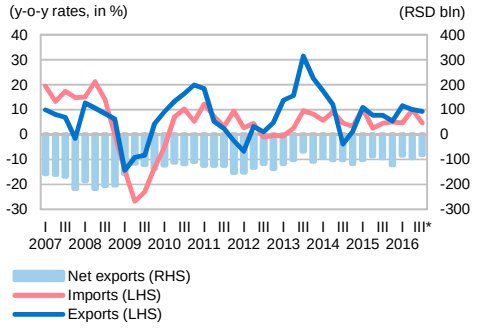
After relatively high growth in Q1, real exports of goods and services dropped mildly over the subsequent two quarters (by 0.8% and 2.3% s-a, respectively). Still, as opposed to Q2 when the drop in exports was coupled with growth in real imports of goods and services, Q3 saw imports declining as well (2.4% s-a), so the net exports contribution to GDP was positive (0.3 pp).

In Q3, a positive net exports contribution to GDP was recorded in y-o-y terms as well (1.7 pp), given that real exports of goods and services grew much faster than imports. This was a reflection of continued economic growth in the euro area and the implementation of earlier investment, dispersed across a large number of export-oriented projects.

A slowdown in exports of goods and services in Q3 was signalled by the movement of the external demand indicator,[22] which stagnated in Q2 and dropped mildly in Q3 (0.3%). This was largely due to the deterioration of the economic climate in Italy, our main trade partner. On the other hand, there is improved perception of the economic situation in Germany, which accounts for a sizeable portion of our trade activity. In addition, terms of trade deteriorated to some extent, with import prices rising faster than export prices. Price competitiveness, measured by the real effective exchange rate of the dinar vis-à-vis the euro and the dollar remained unchanged in Q3, given that mild nominal depreciation (0.4%) was neutralised by faster growth of domestic relative to foreign prices.

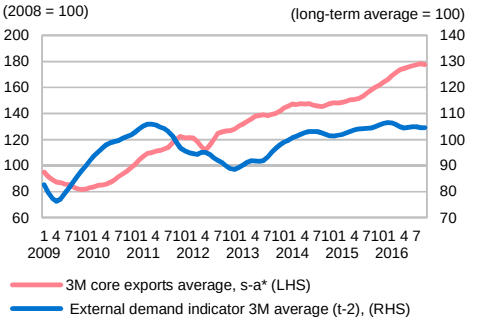
Euro-denominated commodity exports dropped by 2.9% s-a in Q3. Such trend was prompted primarily by lower exports of motor vehicles (11.9% s-a), which may be associated with the downscaling of production in Fiat Automobiles Serbia during the summer months. The

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.

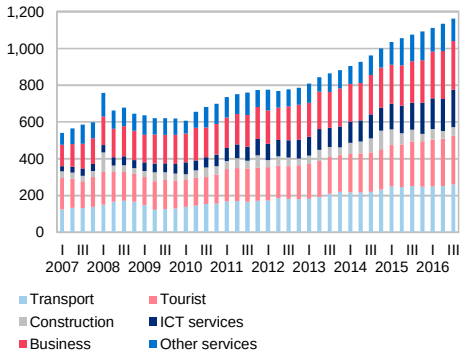
Chart IV.4.5 **Movements in external demand and core exports indicators**



Sources: European Commission, SORS and NBS.
* Excluding agriculture, energy products, motor vehicles and base metals.

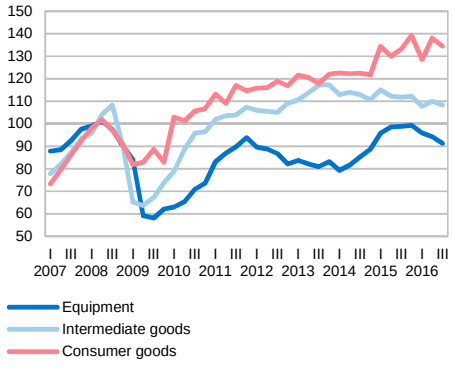
[22] The leading indicator of external demand for Serbian exports was constructed based on movements in the European Sentiment Indicator (ESI). It includes Serbia's 20 most important foriegn trade partners – their shares in Serbian exports being used as weights.

Chart IV.4.6 **Exports of services**
(s-a data, in EUR mln)



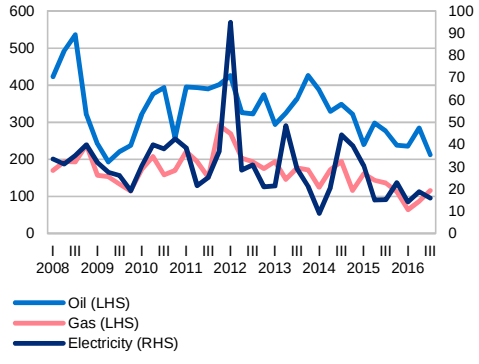
Sources: SORS and NBS calculation.

Chart IV.4.7 **Imports by key components**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Chart IV.4.8 **Energy imports**
(s-a data, in EUR mln)



Sources: SORS and NBS calculation.

company's exports in the first nine months of 2016 equalled EUR 866.6 mln, down by 8.2% y-o-y. Nevertheless, the negative trend in Fiat's exports was largely compensated for by the growth in exports of other companies in the automobile industry (see Text box 2). In addition, food, clothing and electrical equipment exports were also lower in Q3.

Positive trends continued also in exports of petroleum products, which despite the low price, grew by 16.3% s-a. The privatisation of the Smederevo steel plant and the rebound in iron prices in the global market contributed to further growth in base metals exports (10.3% s-a), while contrary to the quarter before, exports of metal and chemical products increased as well. A positive impetus to commodity exports in Q3 came also from higher exports of machinery and equipment.

Exports of agricultural products declined in Q3 (10.1% s-a), mainly due to lower fruit exports, affected by underperforming yields of apples and raspberries. On the other hand, exports of cereals went up, mainly owing to higher wheat exports, which almost doubled in quantity y-o-y. This was the result of higher production (18.8%) and formation of significant export inventories of wheat (around 1.5 mln tons). Agricultural exports are likely to grow by the end of this year and in most of the next year, owing to the above-average yields of corn, our main agricultural export product, where export inventories are estimated at around 3 mln tons.

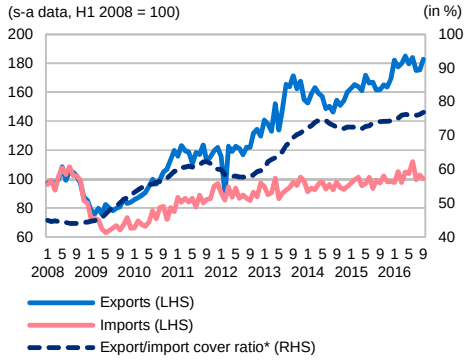
Services exports stayed on an upward path in Q3 (2.5% s-a), driven mainly by higher exports of information and computer services. Exports of tourist, business and transportation services also continued up, while exports of construction services recorded a recovery. In the year to date, services exports increased by 7.4%.

After relatively high growth in Q2, euro-denominated commodity imports fell by 5.6% s-a in Q3. Lower imports were recorded for all components, and the greatest negative contribution came from intermediate goods, which generally account for the major portion of imports. This drop can in part be explained by lower imports of energy, primarily oil, where imports strongly increased in Q2 as the inventories were stocked up, but declined in Q3, due to the planned overhaul in the Pančevo refinery. Apart from imports of intermediate goods, consumer goods imports shrunk as well, reflecting the stagnation of private consumption in Q3, while lower imports of equipment were set off in part by higher domestic production.

The explanation that lower imports of intermediate goods reflect primarily lower imports of energy is also confirmed by the analysis of commodity imports observed by the EU economic destination. Namely, with energy excluded, where imports dropped by 12.2% s-a, imports of intermediate goods in Q3 showed only a mild decline (0.6% s-a).

A milder fall in commodity exports relative to that in imports also led to the improvement in terms of trade indicators. In September, the exports/imports cover ratio, as measured by a 12-month moving average, reached a record high of 76.9%, 0.8 pp more than in June. Also, in s-a terms commodity exports were 82.6% above their pre-crisis level,[23] as opposed to commodity imports which hovered close to where they stood before the crisis.

Chart IV.4.9 **Commodity trade in euros**



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

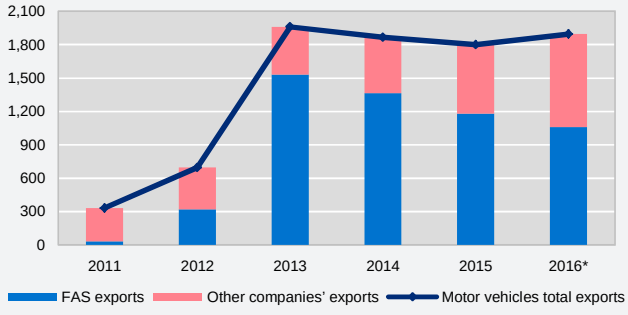
[23] H1 2008.

Text box 2: Automobile industry – fillip to Serbia's industrial and export growth

The 2008 joint investment by the Serbian government and Italy's Fiat in a new company Fiat Automobiles Serbia (FAS) helped revive Serbia's automobile sector. The arrival of the renowned global car manufacturer encouraged its key subcontractors to come to Serbia as well, bringing cutting-edge technologies in addition to creating new jobs. The creation of a favourable investment environment and the existing pool of skilled workers encouraged many other foreign companies, besides Fiat and its subcontractors, to invest their capital and open production facilities in Serbia. These companies were not only manufacturers of motor vehicles, but also companies from other branches related to the automobile industry. Several companies set up plants for steel casting and processing, the manufacturing of pneumatic tyres and rubber parts, or textile products for cars. Most of them channel their total output into exports, thereby helping reduce the external trade imbalance.

Chart O.2.1 shows a strong rise in exports of motor vehicles as early as in H2 2012, which coincides with the start of the mass production in FAS. The all-time high exports figure of EUR 1.531 bln was posted in 2013, the same year when the largest number of vehicles was manufactured (around 114,000). That year, motor vehicle production was the driver of industrial growth and exports, contributing 2.2 pp to the total rise in the physical volume of industrial production which measured 5.5%. In the overall rise in exports (25.8%), motor vehicles accounted for 14.5 pp. During 2014 and 2015, FAS output and exports dropped (to EUR 1.364 bln and EUR 1.178 bln, respectively), owing partly to the previous year's high base and gradual market saturation with the current car model. Consequently, the total exports of the automobile industry edged down during each of those two years. Nonetheless, the automobile industry stayed the strongest branch of exports, accounting for around 15% of Serbia's total commodity exports. FAS stayed the single largest exporter in Serbia and, in terms of operating income, ranked among the top five companies.

Chart O.2.1 **Motor vehicles exports**
(in EUR mln)



Sources: Ministry of Finance, SORS and NBS calculation.

* Projected exports assuming that the average monthly pace of exports in the first nine months will continue until year-end.

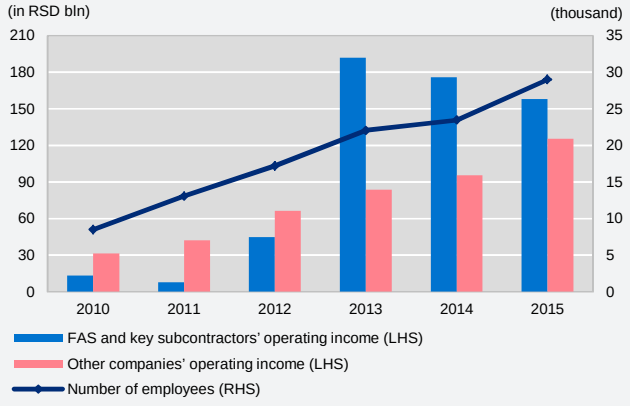
The decrease in output and exports of FAS during 2014 and 2015 was gradually counterbalanced by the expansion of other companies in the automobile industry, owing to the implementation of earlier FDI, scattered across a large number of smaller projects. Based on the January–September trends, the automobile industry exports are expected to rise by around 10% in 2016 (Chart O.2.1). The exports of these companies climbed from EUR 430 mln in 2013 to around EUR 620 mln in 2015, staying nearly unchanged during the first nine months of 2016. The share of these companies' exports in the total exports of motor vehicles consequently increased from around 20% in 2013 to around 35% in 2015, and then to above 40% in 2016. In addition, the exports of rubber and plastic products is also significant – and since it mostly implies the export of pneumatic tyres and rubber parts for cars, the exports of this branch of manufacturing can, in the largest part, be calculated towards the total exports of the automobile industry. The fact that these companies have started operating is significant in terms of the diversification of production and greater flexibility of the domestic industry, but also from the perspective of a more balanced regional development, as many of these companies' production plants are located in regions with higher unemployment rates and lower average income.

The data from the Business Registers Agency on the business operations of the 40 largest automobile industry enterprises in the 2010–2015 period indicate a constant rise in operating income and labour force (Chart O.2.2). Similarly to exports, the operating income of FAS, its key subcontractors and other automobile industry companies also showed diverging movements. Until 2013, the operating income of FAS and its subcontractors rose strongly, sliding thereafter

throughout 2014 and 2015. Other companies saw a constant rise during this period, increasing their share in total operating income of the automobile industry. The number of employees in the automobile industry was on a steady upward path and reached nearly 30,000 in 2015. Employment followed a similar trend as did the operating income – the number of FAS employees dropped, while that of other companies increased.

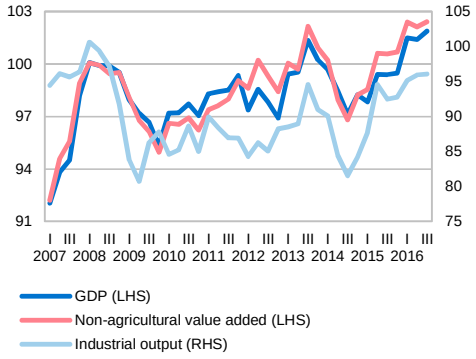
In addition to their current contribution to industrial expansion and the rise in exports, the manufacturing of motor vehicles and rubber and plastic products should remain a fillip to growth in industry and exports in the coming period. The share of net FDI inflow to these branches in 2014 and 2015 equalled around 40% of the total inflow of capital to the manufacturing sector. As the full effects of these investments are yet to be felt in the current and the following years, the automobile industry may give a significant positive contribution to the industrial production, exports and employment in the coming years.

Chart O.2.2 **Automobile industry key performance indicators**



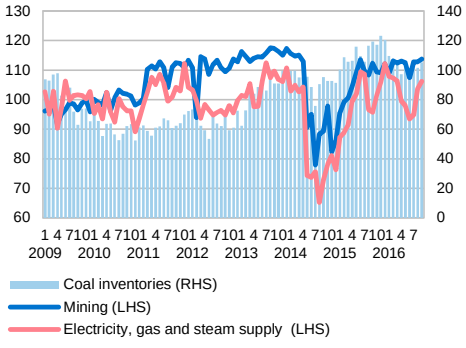
Sources: Business Registers Agency and NBS calculation.

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



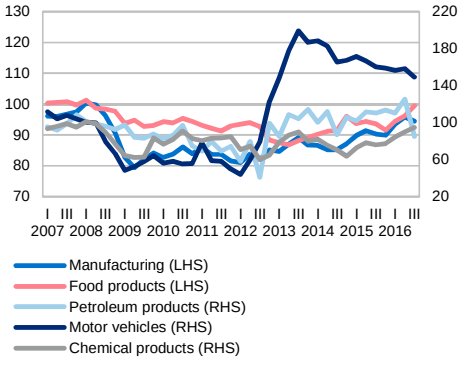
Sources: SORS and NBS calculation.

Chart IV.5.2 **Physical volume of production in energy and mining**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Chart IV.5.3 **Physical volume of production by branches of manufacturing**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

5. Economic activity

The successful agricultural season and continuation of positive tendencies in the industry and construction reflected positively on economic activity which surpassed its pre-crisis level early in the year and continued to grow in the aftermath. According to the NBS, GDP growth in Q3 measured 0.5% s-a and was driven mainly by agriculture. The Serbian Statistical Office's preliminary estimate suggests that growth accelerated to 2.5% y-o-y.

NBS projections put GDP growth in 2016 at 2.7%, which is the third upward revision since the start of the year. Faster than expected growth will be spurred by the above-average agricultural output and continued positive contributions of the industry, construction and the majority of service sectors.

According to the NBS estimate, GDP stagnated in Q2 and grew by 0.5% s-a in Q3. The growth was mainly aided by agricultural output, which in the latest season outperformed multi-year yields (see Text box 3). Also, on the back of earlier investment, low financing costs and growth in the economic activity of the euro area, industrial production continued to grow. Legislative improvements and continued intensive implementation of infrastructure projects reflected positively on construction, while the recovering household consumption gave an impetus to some of the service sectors. Owing to positive trends over the last two years, economic activity reached its pre-crisis level[24] early in 2016 and surpassed it in Q3 – by 1.9% measured by GDP, or by 2.4% measured by NAVA.

According to the preliminary estimate of the Serbian Statistical Office, GDP grew by 2.5% y-o-y in Q3, which is above the NBS initial expectations (1.8% y-o-y). Such trends, coupled with H1 results (2.9% y-o-y), justify an upward revision in annual GDP growth to 2.7%. Similarly as on a quarterly basis, we estimate that the greatest positive contribution to GDP growth in Q3 came from agriculture. In addition, the industry, construction and the majority of service sectors also stayed on an upward path.

After a relatively robust growth in H1, the physical volume of industrial production rose by a moderate 0.2% s-a in Q3. A positive impetus came from the recovered production in mining and energy (1.9% and 4.8% s-a,

[24] H1 2008.

respectively), as the overhauled capacities gradually resumed their operation. A contraction in the physical volume was recorded in manufacturing (1.5% s-a), mostly owing to lower production of petroleum products (32.2% s-a) after the overhaul of the Pančevo refinery in September.

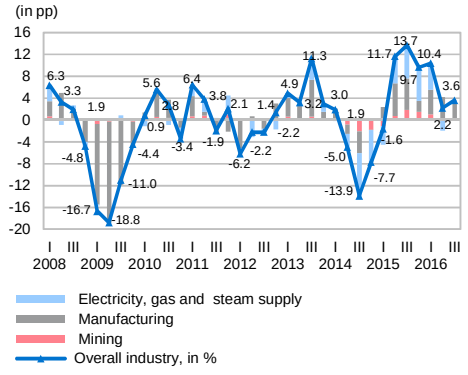
A drop in the physical volume of production in manufacturing was nevertheless lower than expected owing to good results in the production of food, base metals, machinery and equipment and chemical and pharmaceutical products. The effects of a good agricultural season already in Q3 reflected on food production which grew by 3.3% in Q3. Base metals also recorded higher output, owing to intensified production in the Smederevo steel plant after its privatisation, which may also be associated with a rise in global iron prices. On the other hand, the physical volume contracted in the production of rubber and plastics products, motor vehicles, electrical equipment and computers.

Y-o-y, the physical volume of industrial production accelerated slightly in Q3 (to 3.6%), reflecting positive contributions from all of the three sectors. The greatest impetus came from manufacturing (3.2 pp), where growth was extended (in 16 of the 24 branches) owing to positive tendencies in the food industry and the majority of other export-oriented branches. Also, the completion of overhaul in some energy and power plants increased the physical volume of production in mining (3.3%) and electricity, gas and steam supply (1.1%) sectors, each adding 0.2 pp to the physical volume of the overall industry.

Based on the available indicators, we estimate that construction will also record further growth. In Q3, the value of works performed in this sector rose by 7.0% y-o-y, while a continued rise in construction permits was recorded in both July and August. Also, government capital expenditure remained relatively high in Q3, which is a sign of continued implementation of infrastructure projects. On the other hand, though the production of construction material stagnated in Q3, it nevertheless remained higher in the first nine months of 2016, compared to the same period last year.

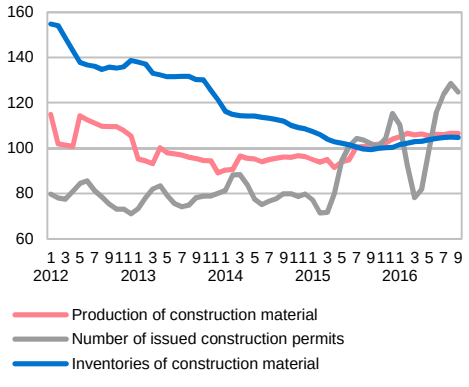
Weather conditions this year were conducive to almost all agricultural crops, which, given the higher investment in production, resulted in over-average yields. Relatively

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



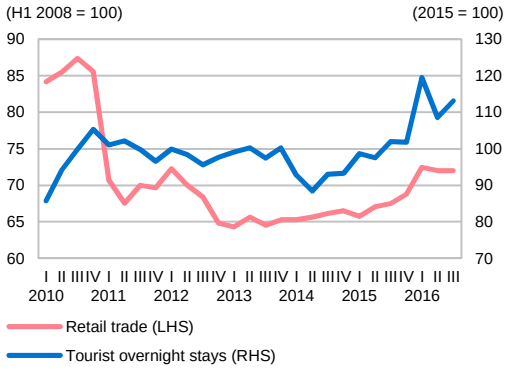
Sources: SORS and NBS calculation.

Chart IV.5.5. **Construction activity indicators**
(3M averages s-a, 2015 = 100)



Sources: SORS and NBS calculation.

Chart IV.5.6 **Service sector indicators**
(s-a data)



Sources: SORS and NBS calculation.

Table IV.5.1 **Contributions to quarterly GDP growth** (in pp)

	2015		2016		
	Q3	Q4	Q1	Q2	Q3*
GDP (s-a, in %)	**0.0**	**0.1**	**2.0**	**-0.1**	**0.5**
Agriculture	0.0	0.1	0.4	0.0	0.2
Industry	-0.5	-0.3	0.7	0.2	0.1
Construction	0.1	0.1	0.1	0.0	0.1
Services	0.4	-0.1	0.7	0.2	0.0
Net taxes	0.2	0.0	0.1	0.0	0.0

Sources: SORS and NBS calculation.

* NBS estimate.

high growth was achieved in wheat production (18.8%), and according to the preliminary estimates of the Serbian Statistical Office, also in corn (36.6%) and industrial plants. A production boost is expected in fruit growing as well, owing largely to better plum yields, while wine growing is likely to see a contraction. Based on the available data, we estimate that animal husbandry will stagnate in 2016 as lower pork production in H1 should be compensated for by its growth in H2, as well as by higher production of beef, milk and dairy products. According to our estimate, in 2016, agriculture should grow by around 12%, giving a positive 1.0 pp contribution to GDP growth.

The continuation of positive trends was also recorded in some service sectors. While stagnating in Q3, retail trade growth remained relatively high y-o-y (6.8%). Tourism indicators also suggest growth in activity, given that tourist arrivals posted relatively high y-o-y growth rate (11.8%), and the number of overnight stays also went up (10.8%).

Based on economic activity in the year to date and expectations until the end of 2016, GDP growth in 2016 is estimated at 2.7%. This growth should largely be driven by the recovery in agriculture and continued positive contributions from the industry, construction and the majority of service sectors.

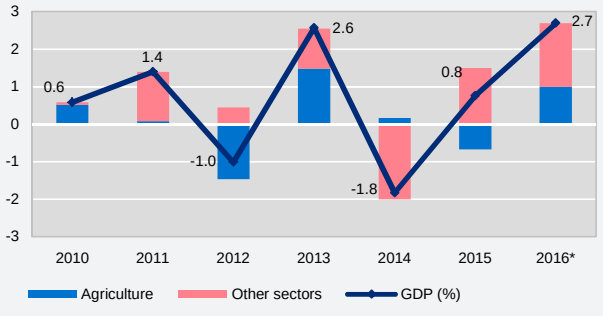
Text box 3: Effect of the new agricultural season on GDP

Agricultural production is a very significant segment of the Serbian economy, as it contributes directly to the creation of value added, and also serves as the base for food industry, i.e. for food, beverage and tobacco manufacturing, while in itself, food industry alone accounts for the major portion of output in manufacturing (nearly 25%). Agricultural production largely depends on weather conditions, the impact of which can be influenced to a degree, yet not entirely eliminated. It is also characterised by low turnover, as the main agricultural crops have one-year production cycle. For statistical purposes, the total annual value added of the agricultural sector is distributed approximately across quarters, using the following weights – 20% for Q1, 25% for Q2, 30% for Q3 and 25% for Q4.

The Serbian agriculture is dominated by the production of plants, which accounts for around 70%, of which 60% is crop production, and around 10% is fruit production and wine growing. This structure is relatively unfavourable from the point of creating value added due to the low share of animal husbandry (30%), the products of which have the greatest value added (meat and meat products, and milk and dairy products). Over the last five years, the share of this segment in the total agricultural production in the EU averaged around 40% and around 35% in the neighbouring countries, such as Hungary and Croatia. By individual crop, corn accounts for the largest share in total agricultural production (25%–30%), followed by wheat (around 6%), and sunflower and soya bean (3% each). Given its high share, fluctuations in corn production are the prime determinant of the fluctuations in the total agricultural production, as was the case in 2012 and 2015. Poor/good corn season indirectly leads to lower/higher activity in animal husbandry, via lower/greater supply and higher/lower price.

During the last seven years, contribution of agriculture to GDP movements (Chart O.3.1) was generally positive, except in 2012 and 2015, when, due to drought, the yield of main agricultural crops dropped below the multi-annual average. In 2012, the drought affected all crops, causing the agricultural production to drop sharply in real terms (17.3%). On the other hand, the 2015 drought primarily affected autumn crops (corn and industrial plants), while summer crops (wheat, barley and oat) were spared, and so the agriculture declined less sharply in real terms (7.7%). After a poor season, the contribution of agriculture to GDP is usually positive the following year. In 2013 (after the poor season of 2012), agricultural production rose 20.9% in real terms, and gave a positive contribution to GDP of 1.5 pp. According to our estimate, agriculture will rise by around 12% in 2016, adding 1.0 pp to GDP.

Chart O.3.1 **Contribution of agriculture to GDP**
(in pp)



Sources: SORS and NBS calculation.
* NBS estimate.

The estimated rise in agricultural production in 2016 is primarily due to the revived production of the main crops which, according to the Statistical Office, posted above-average yields (Table O.3.1). These results were brought about by favourable agrometeorological conditions during the better part of the vegetation period and the use of modern agrotechnical measures, such as modern mechanisation and better-quality seeds. In addition to wheat, whose production went up by nearly a fifth this year, corn production is also expected to rise sharply from the previous year (36.6%) on account of this year's favourable weather conditions.

Table O.3.1 **Agricultural production in 2016**

Agricultural crops/plants	Average yields 2006—2015 (tonne/hectare)	Cropped area in 2016 (hectare, thousand)	Average yields in 2016* (tonne/hectare)	Production in 2016 (tonne, thousand)	Annual growth in 2016 (%)
Wheat	4.0	595.1	4.8	2,884.5	18.8
Corn	5.8	1,020.3	7.3	7,451.3	36.6
Soybean	2.6	185.8	3.2	587.2	29.2
Sunflower	2.4	202.4	3.1	627.7	43.6
Sugar beet	47.0	49.3	51.9	2,560.3	17.3
Plum	5.4	77.9	5.9	328.4	34.4
Apple	15.4	23.7	13.8	463.1	-7.7
Raspberry	6.7	11.0	5.6	61.9	-6.5
Grape	8.2	21.2	6.9	145.8	-14.5

Sources: SORS and NBS calculation.
* SORS estimate.

Wheat and corn are significant export products and their higher output in this agricultural season should provide for higher exports. Food balance sheets of the Ministry of Agriculture and Environmental Protection and Žita Srbije (Serbian wheat and oilseed crops production and export association), which include the latest yield projections, indicate that the available amount of wheat for exports in the current marketing year (July 2016 – June 2017) equals around 1.5 mln tonnes, approximately 40% more than was exported in the previous marketing year (July 2015 – June 2016). From July to September this year, already around 600,000 tonnes of wheat (40% of the total available) were exported. The estimated amount of corn available for exports in the current marketing year (October 2016 – September 2017) measures around 3 mln tonnes, nearly double the amount posted in the previous marketing year.

It is expected that industrial plants, i.e. soya bean, sunflower and sugar beet will see their outputs go up by 20%–40%. This would directly contribute to GDP, but also create a solid base for the rise in food industry this and the next year. As these crops are the key raw materials in food manufacturing, their higher yields should reduce the pressure on the increase in processed food prices in the coming year.

The yield of the plum, the most widespread fruit culture in Serbia, went up by a third, hence the fruit growing output is expected to climb mildly relative to 2015. On the other hand, reduced yields are expected for apples (7.7%) and raspberries (6.5%), while large plantations of these two fruits, which use modern technologies and channel most of the yields to exports, are likely to see higher output levels. By contrast, following the last year's good season, wine growing is likely to drop by around 15% in 2016.

Indicators show that animal husbandry will stagnate in 2016. Pork production dropped by 3.2% y-o-y in H1, but is expected to recover in H2. A positive contribution to animal husbandry is expected from beef production – which rose by 4.2% y-o-y in H1 – and from stepped-up production of milk and dairy products. Animal husbandry is likely to receive an additional boost from lower production costs which could benefit from this season's solid yield of corn and its anticipated lower price.

Good agricultural results this year will give a greater contribution to GDP than previously expected. Under the earlier GDP projection, we assumed average yields in agriculture and a rise of 3%, providing a 0.2 pp contribution to GDP. According to the latest projection, the contribution of agriculture is estimated at 1.0 pp, which should offset the effects of major overhauls of energy plants and the resulting lower contribution of industry.

6. Labour market developments

Owing to higher employment, the real wage bill remained broadly unchanged though real net wages edged down slightly in Q3. Favourable developments in the labour market continued in Q3 with employment on the rise and unemployment figures declining.

Wages and labour productivity

After five straight quarters of growth, **real net wages** recorded a mild drop in Q3 (0.9% s-a). A somewhat larger decline was registered in real net wages in the private sector relative to those in the public sector. In y-o-y terms, real net wages continued up in Q3 (2.0%), though at a slightly slower pace than in H1.

Real net wages slid down in almost all sectors of the economy, recording the sharpest drop in professional, scientific, innovative and technical activities. A mild decline in wages was recorded across the industry, agriculture and construction. By contrast, real net wages continued to rise in the majority of the service sectors where private undertakings are dominant, most notably transportation, information and communications, and real estate.

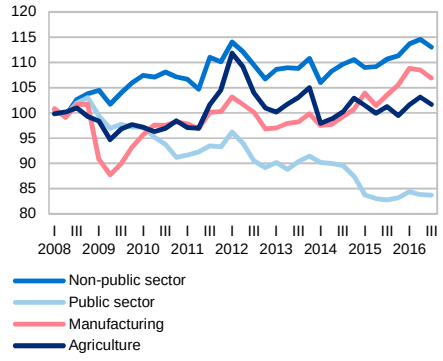
Having grown for five months, the real net wage bill stayed broadly unchanged in Q3 (-0.2% s-a), and the decline in public sector wage bill was almost counterbalanced by the rise in the private sector wage bill. The average nominal net wage paid in Serbia equalled RSD 46,041 in Q3, down by 1.1% from Q2, but up by 3.0% relative to the same period last year.

Despite relatively subdued productivity growth in the overall industry, unit labour costs were reduced in Q3 (0.9% s-a) owing to the lower real gross wage. By contrast, unit labour costs in manufacturing first dipped in Q2 and then rose in Q3, as manufacturing registered a smaller decline in real gross wages compared to the overall industry.

Employment

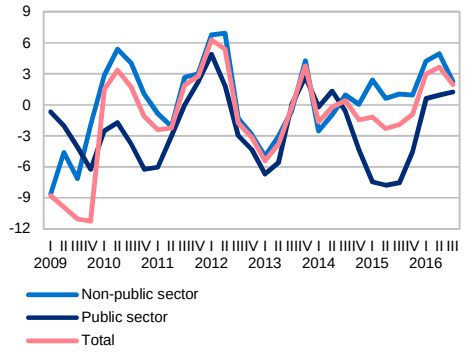
The revival in economic activity and persistent fight against the grey economy continued to reflect positively on movements in the formal segment of the labour market, hence the number of employees increased from the start of the year, while unemployment decreased. Similar trends are indicated by the data obtained from the Labour Force Survey which covers both the formal and informal segments of the labour market.

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



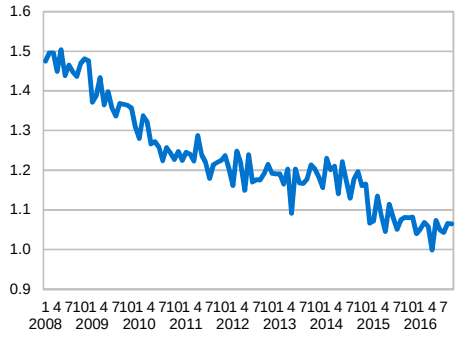
Sources: SORS and NBS calculation.

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



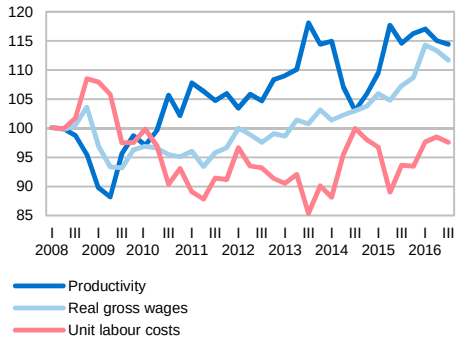
Sources: SORS and NBS calculation.

Chart IV.6.3 **Ratio of average nominal net wage in public and non-public sector**



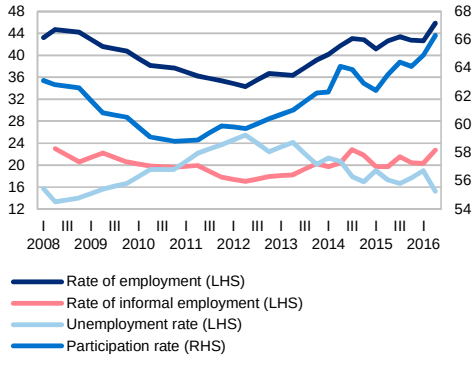
Sources: SORS and NBS calculation.

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.

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



Source: SORS.

Table IV.6.1 **Movements in formal employment and unemployment**
(quarterly growth rates, end-of-period)

	2015	2016		
	Q4	Q1	Q2	Q3
Total number of formally employed	-0.9	0.2	1.6	0.6
Employed with legal persons	-1.2	0.1	1.4	0.7
Entrepreneurs and their employees	0.5	1.1	3.5	1.1
Individual farmers	-1.2	-0.9	-1.1	-2.6
Unemployed persons	-1.6	3.4	-5.7	-3.1
First-time job seekers	-1.7	1.6	-4.7	-2.8
Used to be employed	-1.6	4.4	-6.1	-3.2

Sources: SORS and National Employment Service.

According to data from the Statistical Office's **Central Registry of Compulsory Social Insurance**, formal employment rose by 0.6% in Q3, or by 2.4% relative to end-2015. The biggest contributor to this rise since the start of the year was the increased number of employees with legal entities, as well as the larger number of private entrepreneurs and their employees.

By sector, the rise in employment in Q3 was most pronounced in manufacturing, trade and construction. An increase along similar lines has been recorded since the start of the year. Another evident growth in employment since the beginning of the year was registered in administrative and support service activities, as well as in the accommodation and food sector. Conversely, with the rightsizing of employment levels in the public sector, Q3 saw a reduction in the number of employees in public administration, health and education, as well as in electricity, gas and steam supply, and the water supply sectors, where public-owned enterprises are dominant.

The upswing in employment was accompanied by a reduction in unemployment numbers. According to the **National Employment Service**, unemployment equalled 684,820 persons in September, down by around 20,000 from June and by around 40,000 from end-2015. What is more, this is the lowest unemployment figure in the last 15 years. Unemployment declined across almost all occupational groups, while the sharpest fall was posted by trade, tourism and catering, and also in occupational groups linked to manufacturing. At the same time, the number of people receiving unemployment benefits also declined, reaching its lowest level in five years this September – 39,894 persons.

The **Labour Force Survey** data available for H1 affirm favourable movements in the formal segment of the labour market. Thus, Q3 employment rate went up 3.2 pp to 45.9% from end-2015, reaching its highest level in two and a half years, or since comparable data have become available. In the same period, unemployment dropped to the lowest comparable level (15.2%), down by 2.5 pp from end-2015. Reflecting the general decline in unemployment rates, youth unemployment (15–24 years) also receded to 36.1% in Q2, down by 8.9 pp relative to end-2015.

The rise in employment is partly attributable to higher informal employment which, after falling for two quarters, edged up by 2.4 pp to 22.7% in Q2. Such movements in informal employment could partly be ascribed to seasonal trends, considering that informal

employment typically rises in Q2 and Q3 due to the increased need for seasonal workers in agriculture, construction and certain service sectors.

This is also indicated by the analysis of trends in overall employment by economic sector in Q2, showing an increase in the number of workers in agriculture and construction after two quarters of downward movement. Growth in employment continued in the service sectors, while employment in industry – after declining in Q1 – returned to its end-2015 level in Q2.

7. International environment

The global trade slump, the UK's withdrawal from the EU and uncertainty surrounding policy measures of leading central banks are slowing global recovery, which is, on the other hand, supported by a faster growth of some BRICS countries (Russia and Brazil). The growth in euro area economic activity should continue in Q3 at the pace recorded a quarter earlier, while a mild acceleration is expected in the USA and Central and Eastern Europe.

Inflation is rising steadily both in the euro area and the USA. Announcement of an agreement among major oil producers on limiting output drove up the price of oil, which could induce inflationary pressures going forward.

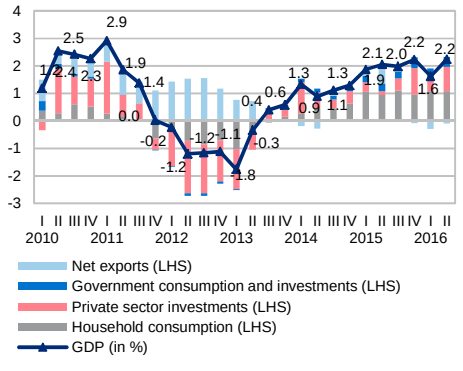
There are still uncertainties in the international financial market over future monetary policy measures of leading central banks.

Economic activity

Economic activity in the euro area continued to grow in Q2 (0.3% s-a), though at a somewhat slower pace than in early 2016. The slowdown resulted from a weaker growth in household consumption, the main driver of economic activity in Q1. The sluggish growth in consumption weighed down on imports, leading to a positive contribution of net exports to GDP.

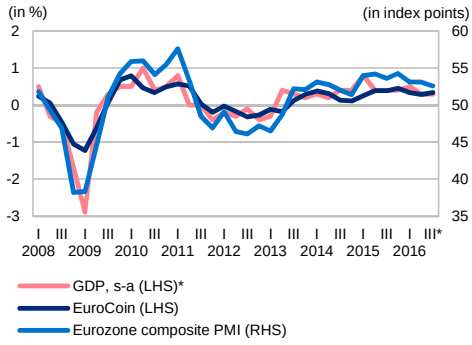
Q-o-q, GDP grew in all countries except France, where a mild decline (0.1% s-a) resulted from household consumption returning to normal levels after strong growth in Q1. In Germany GDP continued up (0.4% s-a), still driven by high domestic demand and favourable labour market developments, while Italy saw stagnation resulting from weaker household consumption and depressed investment.

Chart IV.7.1 **Contributions to y-o-y GDP growth rate of the euro area**
(in pp)



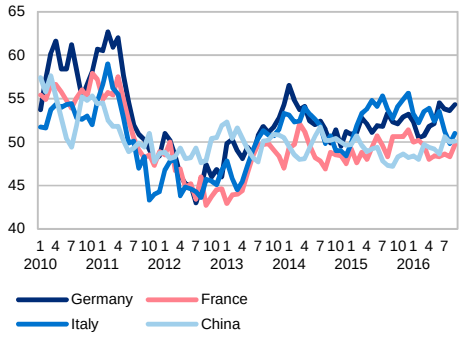
Source: Eurostat.

Chart IV.7.2 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)



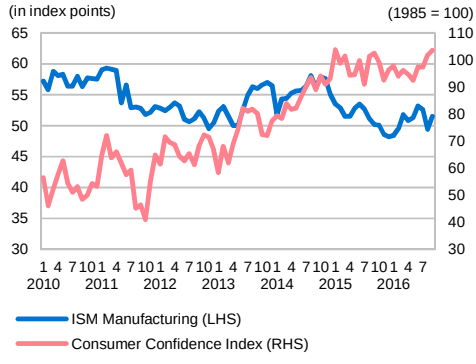
Sources: Eurostat, Markit Group and Banca d'Italia.
* Eurostat's preliminary flash estimate.

Chart IV.7.3 **PMI Manufacturing for selected countries**
(in index points)



Source: Markit Group.

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



Source: Institute for Supply Management, Conference Board.

Based on the movements of key indicators, it is estimated that economic activity in Q3 stayed the same as in Q2 (0.3% s-a). This is confirmed by Eurostat's flash estimate. The composite index of euro area economic activity continued to move above 50 points in Q3 and averaged 52.9, close to the Q2 level. The Economic Sentiment Indicator stayed at a similar level as in Q2, while the unemployment rate declined to 10.0% in September.

The latest IMF forecast predicts euro area GDP growth of 1.7% in 2016 and a mild slowdown to 1.5% in 2017, which is 0.1 pp higher than the July forecast for both this and next year. The upward revision for 2016 resulted from good performance in H1, while the projection for 2017 was revised up owing to weaker negative effects of Brexit than expected. According to Consensus Forecast, growth will be somewhat lower – 1.6% in 2016 and 1.3% in 2017. Looking ahead, growth should continue to be driven by domestic demand, i.e. household consumption and investment thanks to the positive effects of past monetary easing, favourable labour market trends and improved profitability of companies. On the other hand, slower global recovery and the UK's withdrawal from the EU are likely to lessen the contribution of external demand to economic growth in the period ahead.

Continued growth in private consumption and recovery of exports supported the acceleration of **GDP** growth in the **USA** to 0.3% s-a in Q2, while the decline in inventories and government consumption acted as a drag. Although the movement of key indicators suggested that growth would be somewhat lower in Q3, preliminary estimates indicate that GDP increased by as much as 0.7% s-a owing to a surprisingly robust growth in exports and the recovery of inventories. Household consumption contributed the most to GDP growth in Q3, which is confirmed by movements in consumer confidence, whose index reached a 20-month high in September. The rise in household consumption is underpinned also by continued favourable labour market trends, i.e. higher rate of employment and nonfarm payroll gains. On the other hand, ISM Manufacturing on average declined in Q3 compared to Q2.

Given the slower than expected growth in economic activity in H1, muted investment activity and shrinking inventories, the IMF decided to revise downward its outlook for US growth for 2016 (by 0.6 pp to 1.6%) and 2017 (by 0.3 pp to 2.2%). The latest Consensus Forecast estimate predicts similar growth for 2016 (1.5%).

The growth in **economic activity in Central and Eastern Europe** accelerated in Q2, driven primarily by private consumption, still positively affected by the

recovery of the labour market and monetary and fiscal easing. Based on movements of key indicators in most countries in the region, economic growth should continue at a similar pace in Q3. The highest GDP growth in Q2 was again recorded in Romania (6.0% y- o-y), while its pace gathered in most of the other countries in the region compared to the start of the year. Faster economic growth was also noted in most countries of Southeast Europe, owing to continued favourable trends in investment, the recovery of private consumption and the improved labour market situation. Following the recovery of oil prices and a good agricultural season, **economic activity in Russia** turned out better than expected, which prompted the IMF to raise its GDP growth forecast for this and the following year to -0.8% and 1.1%, respectively.

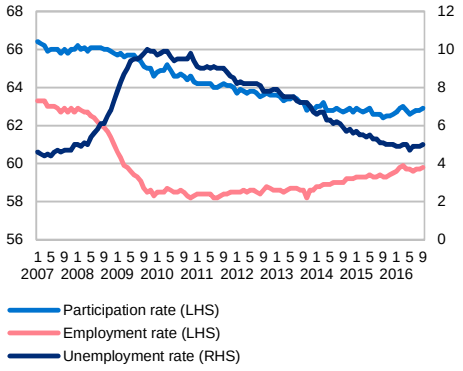
China's economy continued to grow in Q3 at the pace recorded in H1 (6.7% y-o-y), mainly on the back of continued implementation of government infrastructure projects. PMI Manufacturing recorded a value above 50 points, pointing to a slight recovery of the manufacturing sector, while overall industrial production grew at a rate of 6.1% y-o-y on average. Positive movements continued in the service sector as well, which is indicated by a mild acceleration in the y-o-y growth in retail turnover to 10.5% in Q3. On the other hand, risks to growth sustainability can be seen in high corporate debt and rising prices of real estate. According to the latest IMF estimate, China's growth is expected to reach 6.6% in 2016 and slow down to 6.2% in 2017.

Inflation movements

Though still low, **euro area** inflation has been in the positive territory since June. It rose from 0.2% y-o-y in July and August to 0.4% in September, its highest level since July 2014. As the ECB underlined, higher inflation is a reflection of continued y-o-y growth in energy prices, though there are still no signs of a convincing upward inflation trend. In fact, inflation failed to recover significantly primarily because of the indirect effects of the oil price slump in the previous period.

Based on oil futures, the ECB expects inflation to be higher in the coming months, largely due to the base effect of energy prices, which is confirmed by the preliminary estimate of y-o-y inflation of 0.5% in October. The gradual rise in inflation should extend into 2017 and 2018, supported by the accommodative monetary policy stance and expectations of economic recovery. According to the October ECB Survey of Professional Forecasters, inflation expectations stand at 0.2% for 2016, 1.2% for 2017 and 1.4% for 2018,

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



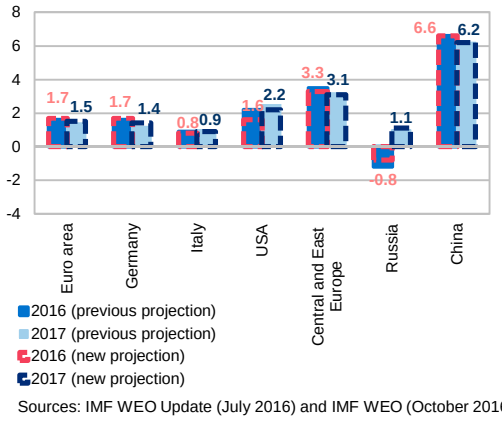
Source: Bureau of Labor Statistics.

Table IV.7.1 **Economic growth estimate by country**
(in %)

	Consensus Forecast October 2016		IMF October 2016	
	2016	2017	2016	2017
Poland	3.1	3.3	3.1	3.4
Czech Republic	2.5	2.5	2.5	2.7
Hungary	2.0	2.6	2.0	2.5
Albania	3.3	3.6	3.4	3.7
Bulgaria	2.8	2.8	3.0	2.8
Bosnia and Herzegovina	2.7	3.0	3.0	3.2
Macedonia	2.6	3.4	2.2	3.5
Montenegro	-	-	5.1	3.6
Romania	4.8	3.3	5.0	3.8
Slovenia	2.1	2.3	2.3	1.8
Croatia	2.4	2.2	1.9	2.1

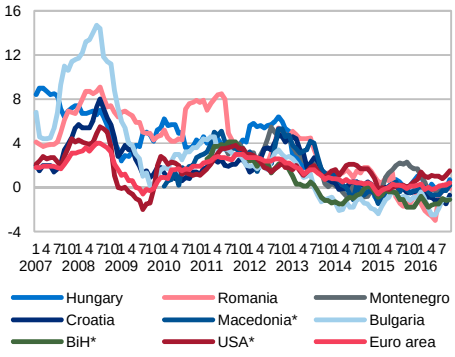
Sources: Consensus Forecast, IMF.

Chart IV.7.6 **Revisions of real GDP growth forecasts for 2016 and 2017 by the IMF**
(in %)



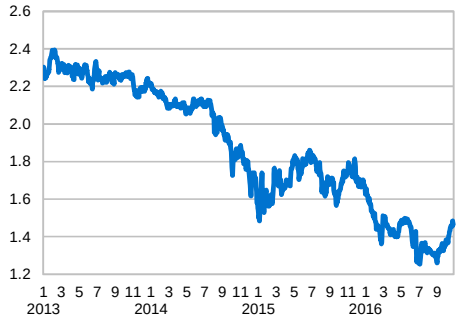
Sources: IMF WEO Update (July 2016) and IMF WEO (October 2016).

Chart IV.7.7 **HICP across selected countries**
(y-o-y rates, in %)



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

Chart IV.7.8 **Long-term inflation expectations in the euro area**
(in %)



Source: Thomson Reuters.

showing a decline by 0.1 pp for 2016 and 2018 compared to the July survey, while expectations for 2017 stayed the same. Long-term inflation expectations (for 2021) remained at 1.8%. These survey-based inflation expectations are still higher than market expectations, although the latter did start rising. Thus, at end-October the market expected that five-year ahead inflation (in the year 2021 for the year 2026) would be 1.47% (while in early September the expectations stood at 1.26%).[25]

Negative y-o-y inflation persisted in Q3 in many **Central and Eastern European** countries. Though milder than in the previous quarter, deflation continued to challenge the markets of Bulgaria, BiH and Croatia. After negative and zero inflation in the preceding months, Hungary, Macedonia and Montenegro saw positive inflation in September. On the other hand, inflation in Russia and Turkey stayed relatively high, despite declining in Q3 to 6.4% and 7.3% y-o-y, respectively in September.

US inflation trended steadily up in Q3, reaching 1.5% in September, the highest rate since October 2014. Inflation is still below target, mostly due to the past decline in energy prices and import prices of other products and services. Core inflation (excluding energy and food prices) equalled 2.2% y-o-y.

Monetary policy

The ECB, the Bank of England and the Bank of Japan are still pursuing accommodative monetary policies. The Chinese central bank is also stimulating economic growth. Conversely, the Fed is on the path of monetary policy normalisation, though milder than previously expected.

Noting that the monetary policy measures undertaken since June 2014 are effectively supporting the recovery of euro area economy, the **ECB** did not change its policy rate or its asset purchase programme. The programme has been kept at the level of around EUR 80 bln per month until end-March 2017. Market participants did not anticipate a policy rate change, but they did expect the asset purchase programme to be extended until September 2017. Uncertainty over the ECB's monetary policy measures caused instability in the European financial market. For instance, yields on German ten-year government securities went in and out of negative

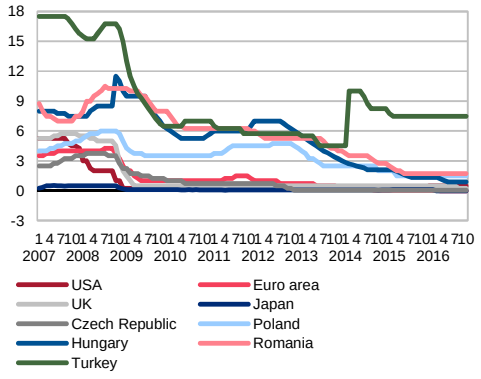
[25] The five-year, five-year breakeven forward.

territory in September and October, while yields on government securities of other euro area countries also oscillated in this period. At its October meeting, the ECB stressed that the undertaken monetary policy measures have filtered through to the real economy and that it expects moderate, but stable economic growth in the coming period, driven primarily by domestic demand.

While the **Fed's** Monetary Board is satisfied with the progress of the US economy in principle, it has not yet decided to further raise its policy rate, but has kept it in the interval 0.25–0.50%. At its September and November meetings, the Fed underscored that the arguments in favour of a policy rate increase are stronger, but that it would wait for further evidence of progress in the labour market and the return of inflation to the 2.0% target.

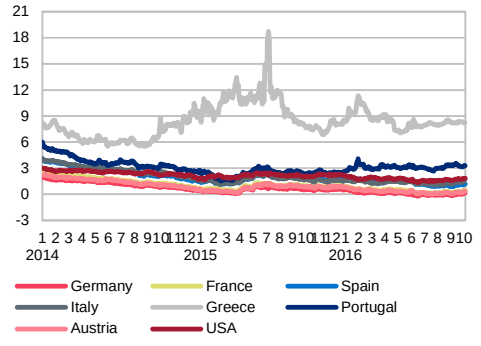
Of the countries in **Central and Eastern Europe**, the Russian central bank, following the June cut, again lowered its policy rate in September, by 0.5 pp to 10%. Markets expected such a decision given the bank's announcement that it would cut the policy rate following a slowdown in inflation and a decline in inflation expectations. At the moment, the Bank of Russia expects that the policy rate will stay at 10% until end-2016. The Turkish central bank cut the lending facilities rate for the seventh consecutive month in September to 8.25%. The deposit facilities rate and the policy rate stayed the same (at 7.25% and 7.50%, respectively). Other countries in the region kept their policy rates unchanged at relatively low levels. Although its rate remained the same, the central bank of Hungary introduced a cap on the liquidity that can be withdrawn in three-month deposit auctions with the intent to further stimulate the interbank market. In October, it decided to cut its reserve requirement ratio from 2% to 1% starting from December, and to lower its lending facilities rate by 10 bp to 1.05%. The central bank of Romania lowered its reserve requirement ratio on FX liabilities from 12% to 10%, while the ratio on leu liabilities stayed at 8%. This is a part of the process of harmonising the reserve requirements mechanism with current standards and practices of the ECB. According to estimates, this measure will release around EUR 500 mln.

Chart IV.7.9 **Policy rates across selected countries**
(annual level, in %)



Sources: Central banks of selected countries.

Chart IV.7.10 **Yield on 10-year bonds of selected countries**
(daily data, in %)

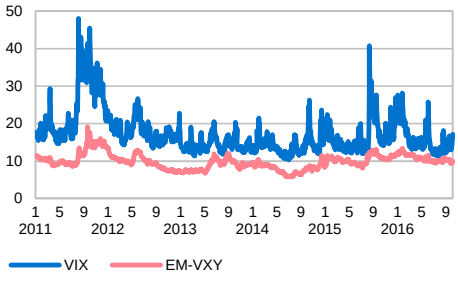


Source: Bloomberg.

Financial and commodity markets

Movements in the financial markets are determined by investors' estimates concerning the activities of leading

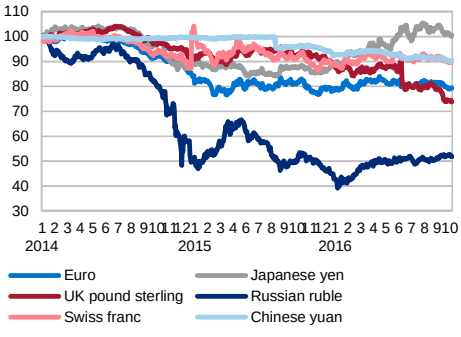
Chart IV.7.11 **Implied volatility of the global financial market***
(in %)



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.

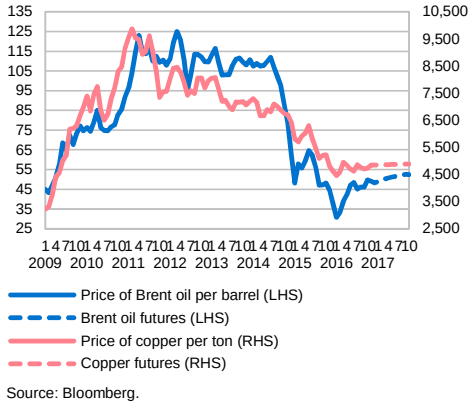
Chart IV.7.12 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



Source: IMF.

* Growth indicates appreciation.

Chart IV.7.13 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

central banks. There were no major changes in **currency movements** in Q3, except in the case of the **pound sterling**, which depreciated against the US dollar by 3.9% due to the Brexit-related uncertainty, and by an additional 6.1% in October. **The euro strengthened against the US dollar** by 0.5% in Q3. The exchange rate moved in the interval between 1.10 to 1.13 dollars for one euro, and weakened by 1.9% in October. On 1 October, the Chinese renminbi was included in the IMF's SDR basket with a 10.92% share, beside the US dollar (41.73%), euro (30.93%), yen (8.33%) and pound sterling (8.09%), which confirms progress in the implementation of reforms of the Chinese monetary system and FX market.

Investors' expectations regarding monetary policy moves of leading central banks also influenced the **price of gold**. After rising in the previous quarter, it remained relatively stable in Q3, but lost 3.1% in October.

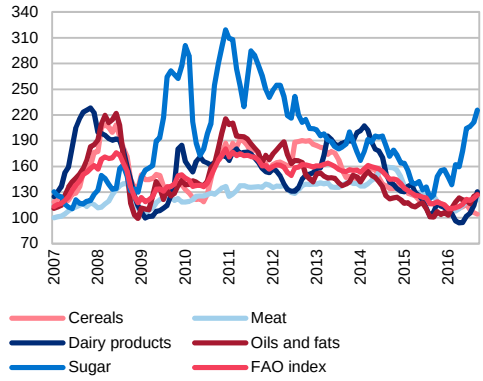
In early July, **oil prices** were close to USD 50 per barrel, but weak demand and the failure of major producers to reach an agreement on the stabilisation of production precipitated their decline to around USD 41 per barrel by end-July. They later started to rise again in anticipation of an agreement between OPEC countries and Russia to freeze production. Prices were also pushed up by the fact that the US oil supply is on the decline. Still, at end-Q3 oil prices were 1.5% lower than at the start of the quarter.

Oil prices continued to rise in early October after the unexpected agreement on lower production reached in late September between Saudi Arabia and Iran, two of the three largest OPEC producers. However, this growth did not last and prices declined by 2.1% in October. According to the October Consensus Forecast estimate, Brent crude oil price should reach around USD 49.1 per barrel in January 2017 and USD 53.7 per barrel in October 2017. Based on oil futures, the price of Brent crude will stand at around USD 46 per barrel in December 2016 and USD 51 per barrel in December 2017.

The gradual increase in **world food prices** continued. Measured by FAO index, their level in September was the highest since March 2015. Except for a mild decline in July, world food prices have continuously grown since the beginning of the year, mostly due to rising sugar prices, and to a lesser extent owing to the growth in the prices of dairy products, meat and vegetable oil. World food prices grew by 4.2% in real terms in Q3 and by 8.5% in y-o-y terms.

Prices of dairy products rose the most in Q3 (27.6% in real terms) because of the increasing probability that, after two years of high supply, exportable surplus of milk will decline, due to lower milk production in the EU, among other things. The growth in sugar prices continued (10.4% in real terms), amounting to as much as 78.5% in y-o-y terms. The increase in sugar prices was predominantly driven by unfavourable weather conditions in Brazil, the world's leading producer and exporter of sugar. Also on the increase in Q3 were prices of vegetable oil (6.2% in real terms) and meat (2.2%). On the other hand, higher global supply led to a decline in cereal prices in Q3, by 10.2% in real terms. This decline was the same in y-o-y terms as well.

Chart IV.7.14 **World food price index**
(in real terms, 2002–2004 = 100)



Source: FAO, UN.

V. Inflation projection

Under our central projection, y-o-y inflation will start rising in the coming months and make its way back within the new target band (3.0% ± 1.5 pp) in early 2017, where it will remain until the end of the projection horizon. Inflation growth will reflect the low base effect from petroleum product prices and a gradual increase in domestic aggregate demand and inflation abroad, while low food production costs, as a result of a good agricultural season this year and a further fall in primary agricultural commodity prices, will continue to hold inflation back. The risks to the projected inflation path are symmetric and relate primarily to future developments in the international commodity and financial markets, and to a certain degree, to administered price growth next year.

Owing to a particularly good agricultural season, GDP growth projection for 2016 has been revised up by 0.2 pp (to 2.7%), while the projection for 2017 remains unchanged (3.0%). Both this and the next year, growth should be driven by investment, exports and final consumption.

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. The projection assumes an active monetary policy which seeks 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.

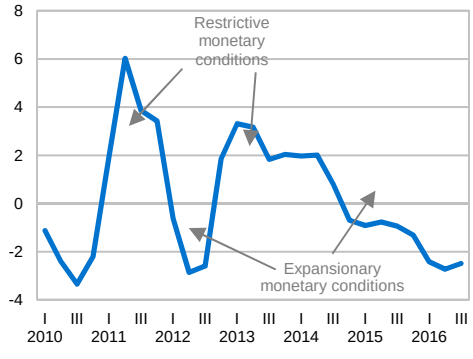
Initial conditions

Consistent with the expectations stated in the August *Report*, y-o-y inflation continued to move below the lower limit of the target tolerance band (4.0% ± 1.5 pp), amounting to 0.6% in September. Like in the previous period, inflationary pressures were subdued under the impact of the majority of domestic factors, as well as low cost-push pressures from international prices of oil and primary agricultural commodities and generally low inflation abroad – especially in the euro area, Serbia's key trade partner. Core inflation (CPI excluding food, energy, alcohol and cigarettes), which has been running below the target tolerance band since August 2014, equalled 1.6% y-o-y in September.

Q-o-q, consumer prices edged up by 0.2% in Q3. While fresh meat and cigarette prices spurred consumer price growth, fruit and vegetable prices worked in the opposite direction.

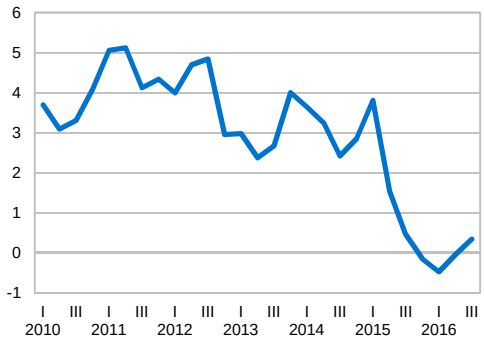
As inflationary pressures have been subdued for an extended period of time, short- and medium-term

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



Source: NBS.

Chart V.0.2 **Real interest rate**
(in %)



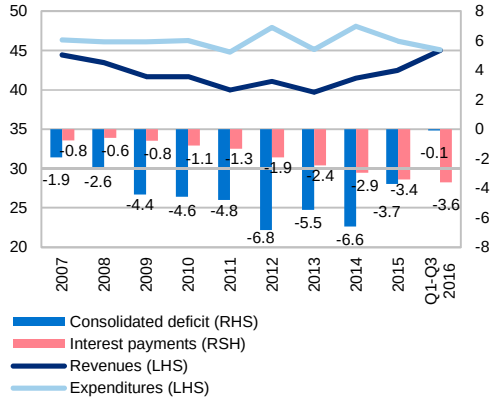
Source: NBS.

inflation expectations of the financial and corporate sectors remained broadly stable and close to the lower edge of the target tolerance band.

The value of the dinar was very stable in both Q3 and October, i.e. almost unchanged at end-October relative to end-June. The period under review (July in particular) was marked by appreciation pressures that were moderated by NBS interventions in the IFEM, i.e. purchases of foreign exchange. Appreciation pressures reflected further improvement in the country's macroeconomic indicators, a positive assessment of Serbia's performance under the programme with the IMF, persistently high inflow of foreign exchange from exports and FDI, lower country risk premium and improved investor sentiment toward emerging markets. In July, pressures were fuelled mainly by increased supply of foreign exchange by non-residents who invested in dinar government securities, but also by the weaker than usual foreign currency demand of domestic enterprises. In Q3 and October, the NBS bought from banks a total of EUR 610.0 mln, of which EUR 355.0 mln in July alone.

The Monetary Conditions Index points to a sustained expansionary monetary policy stance in Q3, which is consistent with the ongoing disinflationary pressures and an open negative output gap. However, the degree of monetary expansion lessened somewhat relative to a quarter earlier due to a rise in the real interest rate.[26] This rise, prompted chiefly by falling inflation expectations, brought the real interest rate in Q3 back to the positive territory. The rate, however, stayed below the neutral level, though less so than in Q2.

Chart V.0.3 **Fiscal trends**
(in % of GDP)



Source: Ministry of Finance.

Fiscal adjustment proceeded in Q3, led by further improvement in public revenue collection. In the first nine months of the year, consolidated budget deficit came at RSD 4.5 bln or 0.1% of GDP, while interest expense excluded, Serbia recorded a primary surplus of 3.5% of GDP. The narrowing of the consolidated budget deficit reflects primarily higher receipts from excise tax, VAT and social contribution payments. Fiscal performance has proved much better than envisaged by the arrangement with the IMF, as the nine months' deficit agreed within the fourth and fifth reviews of the arrangement was RSD 81.3 bln. The IMF estimates that this year's consolidated

[26] 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.

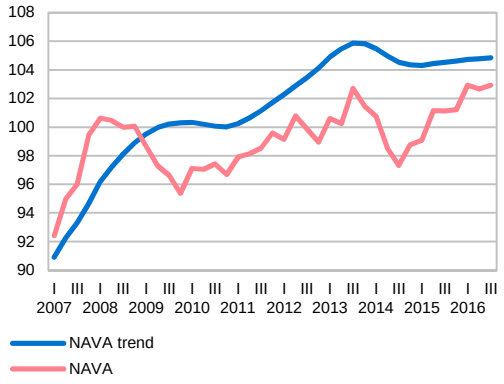
budget deficit will amount to 2.1% of GDP, i.e. 0.4 pp less than expected earlier.

In Q3, GDP grew by 0.5% s-a, stepping up to 2.5% y-o-y. On the production side, the largest positive contribution to growth is estimated to have come from agriculture, owing to a particularly good agricultural season this year, but also from construction and manufacturing. On the expenditure side, GDP growth was led by investment and net exports, while final consumption acted as a drag.

NAVA[27] increased in Q3 by 0.3% s-a, causing a slight narrowing in the negative output gap[28] relative to Q2. This means that the intensity of disinflationary pressures from aggregate demand was somewhat weaker than in the previous quarter.

After the 0.3% s-a growth in Q2, economic activity indicators suggest that the euro area's GDP more or less kept the pace in Q3. The recovery of the euro area economy continues to be supported by low oil prices and the accommodative monetary policy stance of the ECB. The ECB has kept its main interest rate at zero, while its portfolio boasted more than EUR 1,305 bln worth of purchased assets at end-September (the current volume of monthly asset purchases is EUR 80 bln). The Fed has not changed the level of its policy rate since last December and it remains uncertain whether there will be any increase in December this year.

Chart V.0.4 **Output gap**
(Q3 2008 = 100)



Sources: SORS and NBS calculation.

Inflation projection assumptions

External assumptions

The assumption for the euro area's GDP growth in 2016 has been revised slightly upward from the August projection (from 1.5% to 1.6%), while that for the next year has remained unchanged (1.3%).[29] Domestic demand in the euro area will continue to benefit from accommodative monetary policy measures of the ECB and the consequent improvement in financial conditions which is conducive to investment growth, as well as from the recovery of the labour market and persistently low oil prices that have a positive bearing on real disposable income of households and private consumption. However, the risks to euro area growth are tilted to the

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

	2016		2017	
External assumptions	Aug.	Nov.	Aug.	Nov.
EU inflation (annual average)	0.3%	0.2%	1.3%	1.3%
ECB policy rate (year-end)	0.0%	0.0%	0.0%	0.0%
Euro area GDP growth	1.5%	1.6%	1.3%	1.3%
International prices of primary agricult. commodities (Q4 to Q4)*	-6.5%	-10.0%	10.0%	11.0%
Brent oil price per barrel (year-end, USD)	45	46	49	51
Internal assumptions				
Administered prices (Dec to Dec)	3.5%	2.1%	4.0%	4.0%
Trends				
Appreciation trend of the real exchange rate (average)	0.7%	0.6%	0.7%	0.7%
Real interest rate trend (average)	2.0%	2.0%	1.6%	1.6%

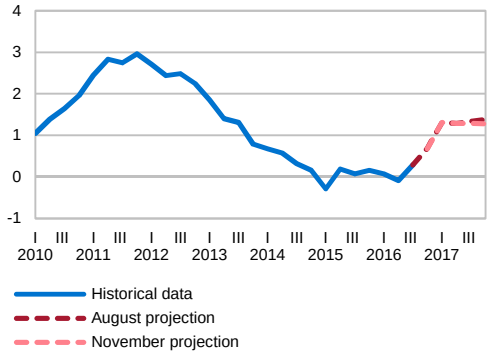
* Composite index of soybean, wheat and corn prices.
Source: NBS.

[27] NAVA (non-agricultural value added) is GDP less agricultral production and net taxes.

[28] Output gap is calculated based on NAVA. NAVA trend estimated by the Kalman filter is used as an approximation of potential output.

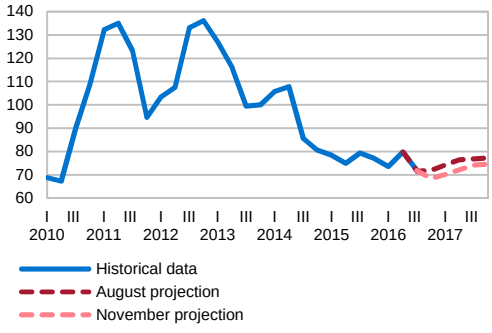
[29] The assumption for the euro area's GDP growth in 2016 and 2017 is consistent with the October Consensus Forecast.

Chart V.0.5 **Assumption for euro area inflation**
(y-o-y growth, in %)



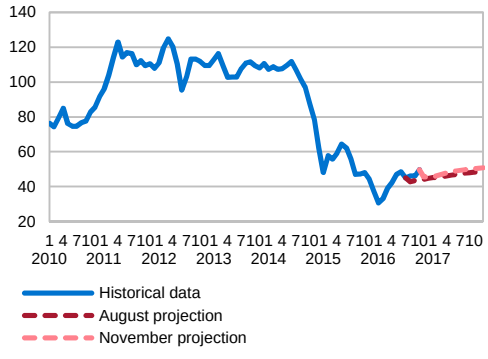
Sources: Consensus Forecast and NBS estimate.

Chart V.0.6 **Assumption for international prices of primary agricultural commodities**
(Q4 2013 = 100)



Sources: BSE, CBOT and NBS.

Chart V.0.7 **Assumption for Brent oil prices**
(USD/barrel)



Sources: Bloomberg and NBS.

downside and relate primarily to the pace of Brexit and uncertainty surrounding the demand for euro area exports.

While staying low, inflation in the currency bloc inched up, ending Q3 at 0.4% y-o-y. It is expected to continue rising next year, supported by the ECB's measures and further economic recovery. However, its rise over the coming several months will largely mirror the low last year's base for energy prices and the expected continuing growth in oil prices. The assumption for average euro area inflation in 2016 and 2017 has remained almost unchanged from the August projection (0.2% and 1.3%, respectively). Given the statements of the ECB officials, we expect that the ECB's main refinancing rate will be kept on hold (0.0%) over the next twelve months and that the monthly asset purchases of EUR 80 bln will continue at least through end-March 2017.

After rising in Q2, international prices of primary agricultural commodities (corn, wheat, soya bean)[30] have been on a decline since mid-year, falling most sharply in July (by around 15%). As the latest data from the futures markets indicate that these prices will fall in Q4 as well, we have revised downward our assumption regarding their movement relative to August. At the same time, futures continue to signal a rise in the prices of primary agricultural commodities in 2017. Though this growth should reach around 11%, these prices will stay relatively low in the context of historical data.

Global oil prices[31] ranged between USD 40 and USD 50 per barrel in Q3, but then jumped over USD 52 per barrel in October on the back of hints that the largest oil producers might reach an agreement to cut output. In early November, however, oil prices headed back down, to around USD 45 per barrel. Based on the latest available futures, oil prices are expected to amount to EUR 46 per barrel at end-2016 and USD 51 per barrel at end-2017. As these levels are still slightly higher than those assumed in August, we have revised our assumption for global oil prices marginally upward.

Internal assumptions

In view of the outlook for international prices of primary agricultural commodities and the influence they have on their counterparts in Serbia, we have assumed that domestic primary agricultural commodity prices will

[30] Measured by the composite index which comprises dollar prices of wheat, corn and soya bean on benchmark commodity markets.
[31] Brent.

record a decrease this year and a moderate increase next year.

The assumption for administered price growth in 2016 has been lowered relative to the August projection. The current projection envisages that this year's administered price growth will amount to 2.1%, adding 0.4 pp to inflation. The main reason for the revision lies in the fact that electricity prices were increased less than previously expected (7.0%). Still, administered price growth this year will be predominantly driven by the increase in prices of electricity (3.8%, 0.2 pp contribution) and cigarettes (4.7%, 0.2 pp contribution). In 2017, administered prices are expected to grow by around 4%.

The results of fiscal consolidation continue to outperform the targets under the arrangement with the IMF. Thus, the reduction of the share of public debt in GDP has already started – a year earlier than planned, and this should help keep the country risk premium relatively stable. Besides, FDI inflow, which is likely to stay more than sufficient to cover the current account deficit financing needs, will provide additional support to the stability of the foreign exchange market going forward.

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

Projection

Inflation projection

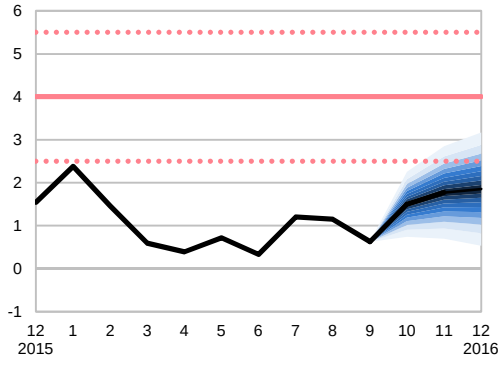
Under our central projection, y-o-y inflation will start rising in the coming months, make its way back within the new target band in early 2017, and continue to move within the band until the end of the projection horizon. As of January 2017, the inflation target will be 3.0% ± 1.5 pp, i.e. 1.0 pp lower.

Short-term inflation projection

Under the short-term projection, y-o-y inflation will rise in Q4, remaining however below the lower bound of this year's target tolerance band (4.0% ± 1.5 pp).

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

Chart V.0.8 **Short-term inflation projection**
(y-o-y rates, in %)



Source: NBS.

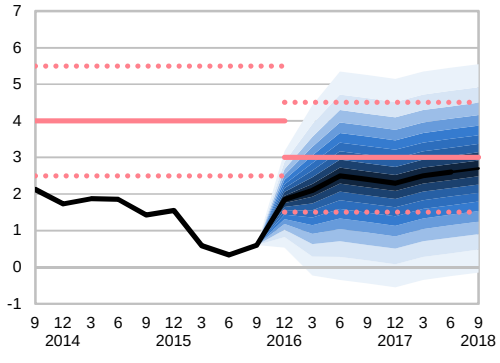
At quarterly level, consumer prices will go up in Q4, led by the prices of energy (higher electricity prices in October and the expected moderate increase in petroleum product prices), industrial products (seasonal growth in prices of clothes and footwear) and services (mainly the seasonal rise in prices of travel packages). On the other hand, the impact of food prices on inflation in Q4 is estimated to be neutral.

Core inflation (CPI excluding food, energy, alcohol and cigarettes) should also continue to move below the lower bound of the target tolerance band in Q4. At quarterly level, core inflation will go up, spurred by the seasonally higher prices of travel packages, clothes and footwear.

Medium-term inflation projection

Y-o-y inflation is projected to enter the new target band (3.0% ± 1.5 pp) in early 2017 and stay therein until the end of the projection horizon (September 2018). Inflation growth will reflect primarily the low base effect from prices of petroleum products and the gradual increase in domestic aggregate demand and inflation abroad (notably the euro area), while low food production costs will continue to produce a dampening effect.

Chart V.0.9 **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%.

Following the downward trend in global oil prices, domestic petroleum product prices decreased from October 2015 to February 2016 by around 10%, knocking around 0.6 pp off the headline inflation rate. As the said price decreases (i.e. low base) will be dropping out from the y-o-y inflation rate in the coming period, the contribution of petroleum product prices to y-o-y inflation will move from the negative into the positive territory until the end of the year. After that, the contribution of petroleum product prices is likely to stay positive, given the expected rise in global oil prices.

This year is likely to see a further recovery in domestic demand, and consequently, weaker disinflationary pressures on account of the negative output gap. The gap opened back in 2008 following the spill-over of the global financial crisis to Serbia, but has been narrowing down over the past two years and is likely to continue on a downward path in the medium term, aided by the past monetary policy easing of the NBS and the ECB's monetary accommodation. The monetary policy stance of the ECB contributes to Serbia's economic growth not

only through stronger demand for our exports, but also through interest rates on euro-indexed loans, given that low interest rates encourage credit and, by extension, economic activity.

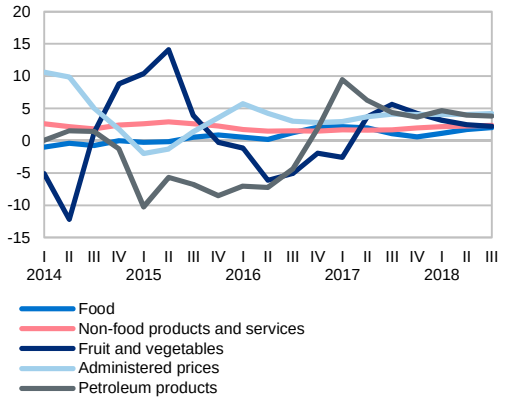
Observed by inflation component, the strengthening of aggregate demand should reflect primarily on the prices of non-food products and services, whose y-o-y growth has been low for quite some time already (averaging 1.8% in the last year). In addition to weak aggregate demand, the reason for this is the low inflation in the international environment which puts downward pressure on our import prices. Hence, we expect that the future growth in euro area inflation and aggregate demand in Serbia will bring about a mild increase in the prices of non-food products and services. Under our central projection, non-food inflation will be close to 2.5% y-o-y at the end of the projection horizon.

Conversely, a dampening effect on inflation in the coming period will come from the low food production costs. The renewed fall in primary agricultural commodity prices (corn, wheat and soya bean) since mid-year has pushed the food production costs further down and widened the negative RMCP[33] gap. In addition, this year's domestic agricultural season was particularly good, which should help sustain the negative contribution of fruit and vegetable prices to y- o-y inflation until the start of the next season. Though its growth will slow down on that account, y-o-y food inflation[34] will not enter the negative territory, as the July and August increases in fresh meat prices are bound to stay in the calculation of inflation over a one-year horizon. While the expected recovery of international prices of primary agricultural commodities next year will provide an impetus to y-o-y food inflation growth from mid-2017 onwards, food inflation is likely to remain relatively low until the end of the projection period (at around 2%).

The risks to the projected inflation path relate primarily to future developments in the international commodity and financial markets, and to a certain degree, to administered price growth next year.

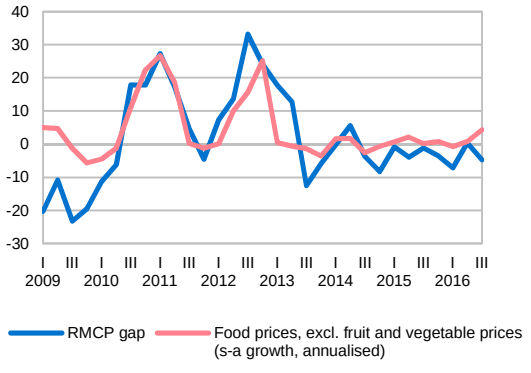
Based on the latest available data from the futures markets, we have assumed that the international prices of primary commodities will rise modestly in 2017.

Chart V.0.10 **Projection of inflation components**
(average y-o-y rate, in %)



Source: NBS.

Chart V.0.11 **Impact of RMCP on food prices**
(in %)



Source: NBS.

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

[35] Food inflation excluding fruit and vegetables.

However, as primary commodity prices are generally rather volatile, the likelihood that they will deviate from the assumed path is not at all negligible. At this point, our estimate is that the prices of oil and primary agricultural commodities are equally likely to deviate in either direction. And having in mind the impact of these prices on prices in Serbia, we may safely assume that actual inflation could also deviate from the projected path in either direction.

The risks associated with developments in the international financial markets continue to be tilted to the upside, mainly because of the expected continued normalisation of the Fed's monetary policy. The increase in the Fed's rate could lead to higher volatility of capital flows to emerging markets, Serbia included. A potentially smaller capital inflow could lead to depreciation of the dinar and ultimately, to some upward pressure on the domestic prices. The accommodative monetary policy stance of the ECB, on the other hand, will continue to work in the opposite direction.

The projection operates on the assumption that administered prices will grow by 2.1% in 2016 and by around 4% in 2017. Having in mind the government's determination to address inefficiencies in public enterprise operation by restructuring those enterprises rather than by raising the prices of their goods and services, it is possible that administered price growth will be lower than assumed. This means that the risks surrounding this category of prices are skewed to the downside.

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

Looking ahead, monetary policy decisions of the NBS will continue to depend on the Executive Board's assessment of the intensity of the (dis)inflationary impact of inflation factors, notably those from the international environment. As so far, the NBS will keep a close eye on developments in the domestic market and international primary commodity and financial markets.

GDP projection

GDP growth projection for 2016 has been revised up for the third time this year. Namely, the new GDP growth projection for 2016 is 2.7%, i.e. 0.2 pp higher than the previous one owing to particularly good agricultural performance. The projection for 2017 remains unchanged from August (3.0%).

On the expenditure side, growth in 2016 will be led by investment and exports, as well as by final consumption. A further increase in investment activity is suggested by a number of factors – improved business environment, more favourable terms of lending to enterprises, increase in government capital expenditure, expected further recovery of the euro area, continuing strong inflow of FDI, and the still relatively low oil prices which act to reduce operating costs for businesses.

Export performances of the Serbian economy remain solid, i.e. exports remain relatively high. On top of that, as imports will rise at a slower pace than exports, net exports will be a positive contributor to GDP growth.

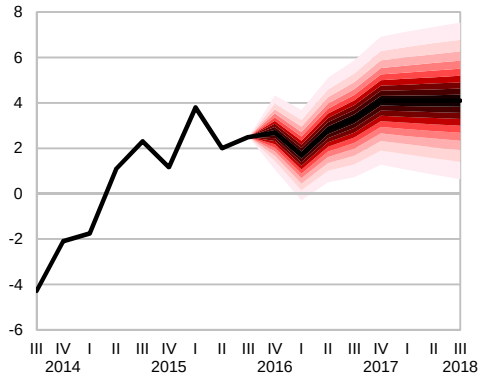
Final household and government consumption will also provide positive contributions, of roughly the same size. Household consumption will be propped up by the real growth in wages and employment in the private sector, as well as by the lower cost of borrowing and the still relatively low oil prices, which have a positive effect on the disposable income of households. On the other hand, an increase in government consumption will be underpinned by higher outlays for the purchase of goods and services.

On the production side, the strongest boost to this year's GDP growth will come from agriculture. According to our estimates, agricultural production increased in 2016 by around 12%, exceeding its ten-year average and contributing 1.0 pp to GDP growth. In addition, higher investment should have a positive impact on manufacturing and construction, whereas buoyed consumption should stir activity in the sector of services. Energy and mining will also give a positive contribution to GDP growth, but that contribution will be relatively small because of this year's major overhauls.

Favourable trends in 2016 should continue in 2017, i.e. economic growth should continue to be underpinned by investment, exports and final consumption. Investment will continue to be the key driver of economic growth, followed probably by household consumption. The strengthening of final consumption will be supported to a degree by the announced increase in the minimum wage, pensions and public sector wages. The contribution of net exports should stay positive and in the region of that recorded in 2016. Economic growth is expected to accelerate further beyond 2017.

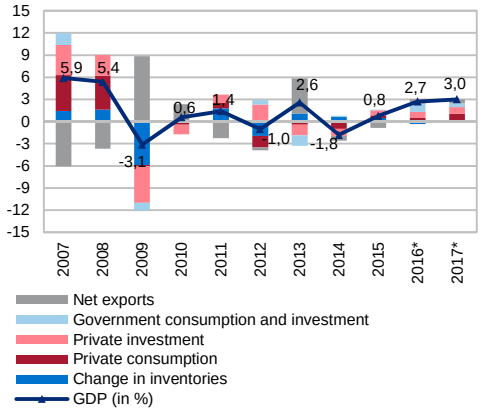
The risks to GDP projection are associated mainly with the speed of economic recovery of the euro area as our

Chart V.0.12 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

Chart V.0.13 **Contributions to real GDP growth**
(in pp)



Sources: SORS and NBS calculation.
* NBS estimate.

key trade partner, and to a certain degree, with the movements in international prices of primary commodities.

The sustained low level of oil prices and unconventional ECB measures could help accelerate the euro area recovery going forward, resulting in stronger demand for our exports and faster investment growth, and thus, higher than projected growth of our economy. Another risk to the upside is embodied in greater use of the EU pre-accession funds as Serbia progresses on its path to the EU. On the other hand, 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. Headwinds to the recovery of the euro area could also come from Brexit. If these downside risks materialised, Serbia would probably see a slowdown in investment and exports in 2017, and consequently, a lower than projected GDP growth.

Symmetric are also the risks associated with global oil prices which may depart from the assumed path equally to the downside as to the upside and thus decelerate or accelerate GDP growth. The prices of primary agricultural commodities and base metals in the international market could also affect our GDP projection, given that Serbia is a net exporter of those products. However, the risks in this context are also judged to be symmetric.

The initiated structural reforms and improvement in the investment and business environment, reflected in Serbia's significant progress on the international competitiveness rankings,[35] enhance the country's medium-term growth prospects. However, the pace of further implementation of structural reforms will determine whether growth will be faster or slower than projected.

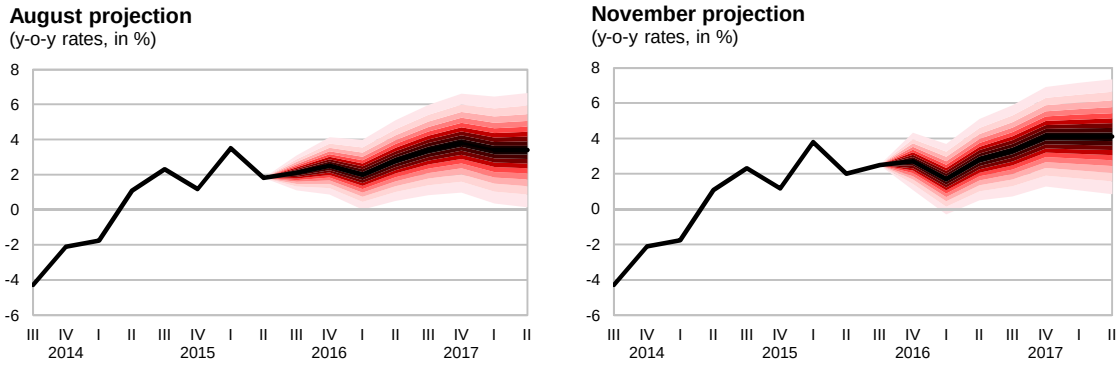
On balance, the risks to GDP projection are judged to be symmetric.

Comparison and outcome of inflation projections

The new inflation projection is lower than in August, but the projection range remains symmetric.

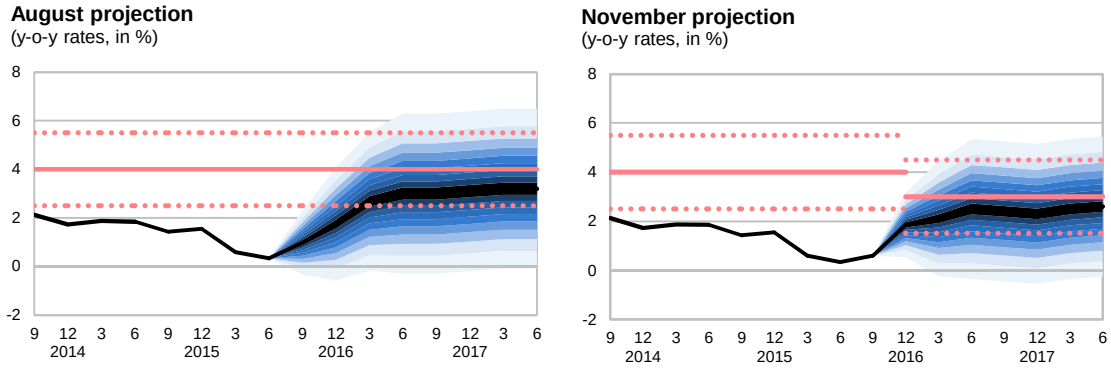
[35] See the latest World Economic Forum's Global Competitiveness Report and the World Bank's Doing Business.

Chart V.0.14 **Current vs. previous GDP growth projection**



Source: NBS.

Chart V.0.15 **Current vs. previous inflation projection**

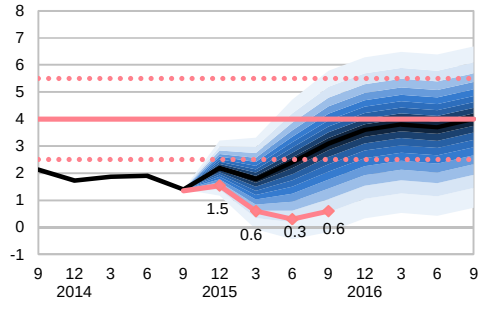


Source: NBS.

The lower projected inflation reflects a downward revision of the assumptions regarding international prices of primary agricultural commodities, as well as lower administered price growth this year which will affect the y-o-y inflation rates over a one-year horizon. Inflation's return within the target tolerance band is now expected in early 2017, though it should be borne in mind that as of January 2017 the inflation target will be by 1.0 pp lower and will equal 3.0% ± 1.5 pp.

In the last twelve months, y-o-y inflation was moving below the November 2015 central projection rate, but within the projection range. Inflation deviated south of the central projection rate mainly because of the stronger than anticipated disinflationary effects from the

Chart V.0.16 **Achievement of November 2015 inflation projection**
(y-o-y rates, in %)



Source: NBS.

international environment. Euro area inflation stayed rather low and exerted downward pressure on our import prices. International primary commodity prices also departed from the level indicated by commodity futures a year ago. Though oil prices recovered this year, the recovery was slower than expected due to their sharp fall in late 2015 and early 2016, while primary agricultural commodity prices declined this year instead of going up as anticipated. Turning to domestic factors, inflation fell short of the projected level mainly as a result of weaker than expected administered price growth[36] (by around 0.5 pp), but also as a result of exceptionally good agricultural season this year which prompted a decline in fruit and vegetable prices.

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

	2016		2017	
	Previous	New	Previous	New
Inflation (annual average, in %)				
IMF	1.3	-	3.2	-
European Commission	1.6	1.1	2.8	2.4
Consensus Forecast	1.5	1.3	3	3.0
Bloomberg	1.4	1.3	2.9	2.5
GDP (%)				
IMF	2.5	2.7	2.8	3.0
European Commission	2.0	2.7	2.5	3.0
Consensus Forecast	2.2	2.4	2.5	2.5
Bloomberg	2.3	2.5	2.5	2.7
Current account deficit (% of GDP)				
IMF	4.2	-	3.9	-
European Commission	4.3	4.4	4.3	4.3
Consensus Forecast*	4.1	3.8	3.9	3.6
Bloomberg	4.2	4.1	4.3	4.0
Fiscal deficit (% of GDP)				
IMF	2.5	2.1	2.6	1.7
European Commission	3.1	2.1	2.9	1.5
Consensus Forecast	-	-	-	-
Bloomberg	3.2	2.5	2.9	2.4

Sources: IMF (Republic of Serbia: Forth and Fifth Reviews under the Stand-By Arrangement, Country Report No. 16/287 and IMF Press Release No. 16/476, November 1, 2016), European Commission (Spring and Autumn Forecast 2016), Consensus Forecast (July and October 2016) and Bloomberg Quarterly Survey (July and October 2016).

* Based on NBS projection of dollar GDP from August and November 2016.

Projections of other institutions

Macroeconomic projections for Serbia by other relevant institutions have improved since the August Inflation Report. Namely, their expectations regarding inflation and the current account and budget deficits have been scaled down, while their expectations regarding Serbia's economic growth have been revised upward.

Overall, these institutions expect average inflation of around 1.3% this year and around 2.8% next year. In terms of economic performance, they forecast Serbia's GDP to grow up to 2.7% this year and up to 3.0% in 2017. Also, most of them expect the current account deficit in 2016 to be slightly above and in 2017 slightly below 4% of GDP. All of them expect the consolidated budget deficit to fall to 2.1–2.5% in 2016 and further down to 1.5–2.4% in 2017.

[36] 2.1% vs. 4.9%.

Text box 4: Favourable fiscal movements and public debt reduction

Since the start of the year, fiscal imbalances have narrowed sharply, reflecting the results of successful fiscal consolidation and structural reforms. Although regular public debt servicing added a further strain on the budget, the general government deficit in the first three quarters of 2016 amounted to only 0.1% of GDP (RSD 4.5 bln), whereas in the corresponding period a year earlier it equalled 1.8% of GDP (RSD 51.1 bln).[1] These results are far better than envisaged during the fourth and fifth reviews of the arrangement with the IMF: general government deficit rising to 2.7% of GDP (RSD 81.3 bln).

Table O.4.1 **Consolidated budget**
(in RSD bln)

	Q1–Q3 2015	Q1–Q3 2016	Q1–Q3 2016/ Q1–Q3 2015 (real terms, in %)
Revenues	**1,237.7**	**1,352.4**	**8.2**
Customs tax	24.1	26.6	9.1
Excise tax	167.3	198.1	17.2
VAT	304.5	331.5	7.8
Income tax	105.7	112.7	5.6
Profit tax	50.4	62.6	22.9
Soc. security contributions	368.2	383.9	3.2
Non-tax revenues	166.0	181.0	8.0
Expenditures	**1,288.8**	**1,356.9**	**4.2**
Expenditures for employees	306.2	308.1	-0.4
Purchase of goods and services	174.7	193.0	9.4
Interest payments	105.7	109.6	2.7
Subsidies	67.8	62.5	-8.7
Soc. wellfare and transfers	515.4	526.5	1.2
pensions	365.9	369.1	-0.1
Capital expenditures	64.0	86.3	33.6
Called guarantees	22.6	28.1	23.5
Budget loans	2.0	2.6	29.6
Total balance	**-51.1**	**-4.5**	
Primary balance	54.6	105.1	
Financing	**65.1**	**-23.3**	
Borrowing	**450.2**	**374.4**	
In the domestic market	388.4	326.3	
In the international market	61.8	48.2	
Debt payments	**385.2**	**397.7**	
Privatisation	**0.6**	**2.0**	

Source: Ministry of Finance.

The sharp cut in the deficit during the first three quarters is chiefly attributable to the sustainable increase in fiscal revenue. In the nine months of 2016, fiscal revenue equalled 45.0% of the estimated GDP for the period, or 2.4 pp above the same period in 2015. The largest increase was recorded in excise tax revenues (0.8 pp of GDP) and VAT (0.5 pp of GDP) due to improved collection of public revenues and a rebound in final consumption. Measured by C-efficiency ratio, the estimated efficiency of VAT collection in 2016 will be 74.4%, up by 3.7 pp relative to 2015.[2] Better business results in 2015 drove corporate profit tax revenue up by 0.3 pp of GDP (or by more than 20% in real terms), as well as the revenues from citizens' contributions and income tax by 0.1 pp of GDP each, owing to more favourable movements in the labour market. Non-tax revenues also rose, by 0.3 pp of GDP (8.0% in real terms).

The significance of such increase is best illustrated by the fact that fiscal revenues were higher than all the savings that were originally planned in the budget and seen as the only way to reduce the budget deficit. In the year to October, savings were mostly made in accordance with the plan: expenditures for employees, pensions and subsidies were reduced (by 0.3 pp of GDP each). At the same time, the share of fiscal expenditures in GDP rose by 0.8 pp, to 45.1% of GDP, primarily on account of capital expenditures increasing by 0.7 pp, to 2.9% of GDP, which is important in terms of future economic growth.

The fiscal rebalancing achieved so far will help to additionally reduce this year's deficit which is estimated at around 2.1% of GDP. This is half the amount planned by the *Fiscal Strategy for 2016 with Projections for 2017 and 2018* (4% of GDP), and at the same time lower than the 2.5% deficit projected during the fourth and fifth reviews of the arrangement with the IMF.

Extensive fiscal efforts normally create a basis for public debt sustainability. At year level, this year's expected deficit will be sufficient to stop the rise in the share of public debt in GDP; moreover, this share is expected to decline – for the first time since 2008 – owing not only to lower fiscal deficit but also to a rise in economic activity. At end-September,

[1] Excluding the rates effect, primary surplus equalled 3.5% of GDP (1.8% in Q1–Q3 2015).

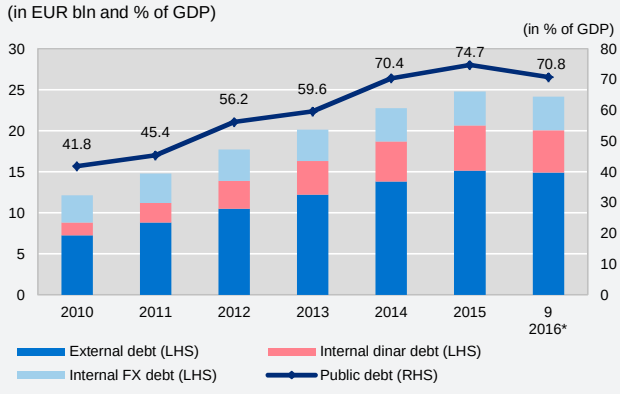
[2] $C-efficiency = \frac{\text{VAT revenue}}{\text{consumption} * \text{standard VAT rate}} * 100$ *C*-efficiency ratio is 100% in conditions when the entire consumption is taxed and there is no tax evasion, and a flat VAT rate is applied.

central government debt equalled EUR 24.1 bln, and its share in the projected GDP was 70.8% (compared to 74.7% of GDP at end-2015). The lower share of public debt in GDP since the beginning of the year is the result of lower internal debt (by EUR 417 mln) and of the external part of public debt (by EUR 238.2 mln), as well as of higher nominal GDP in 2016.

Considering the current level of public debt, as well as the fiscal deficit projection in an environment of continued success in fiscal consolidation and the achievement of macroeconomic assumptions, we estimate that the share of public debt in GDP at the end of 2016 will be lower than last year and will continue to gradually decline in the coming period.[3]

In Serbia, as in other countries, a major risk to the reduction in the share of public debt in GDP comes from movements in the international environment, most notably the strengthening of the dollar (considering that the dollar share of public debt is around 33%), as well as from the rise in interest rates in the international financial market, which will be chiefly determined by the dynamics of the Fed's monetary policy normalisation in the period ahead.

Chart O.4.1 **Public debt**
(in EUR bln and % of GDP)



Source: Ministry of Finance, SORS and NBS calculation.
* Public debt-to-GDP ratio is calculated using the projected GDP for 2016.

With internal imbalances narrowing and public debt declining, there is less need for external financing; this in turn will boost the domestic economy's resilience to challenges coming from the international environment. Also, fiscal consolidation supported by structural reforms leads to sustainable economic growth and lower deficit on the current account of the balance of payments. At the same time, the current internal and external rebalancing leads to greater efficiency of monetary policy measures and lower interest rates, thereby providing a stimulus to growth and improving the resilience of the Serbian economy to external shocks.

[3] Public debt projection excludes the effects of liabilities arising from the Law on Property Restitution and Compensation, which will equal around EUR 2 bln, as well as the effects of possible privatisations.

Table A
Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Q1 2016	Q2 2016	Q3 2016
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	6.6	6.0	5.7	5.9
FX reserves/short-term debt	177.0	265.1	250.6	162.6	220.6	191.2	299.8	237.4	268.9	297.4	278.1	270.1	264.4	
FX reserves /GDP	23.3	36.9	32.7	24.2	34.6	33.6	36.1	34.5	32.7	29.7	31.0	28.7	28.0	28.7
Debt repayment/GDP	5.0	10.3	10.3	10.7	12.8	12.0	12.4	13.0	13.4	14.2	12.0	12.6	13.0	
Debt repayment/exports of goods and services	19.8	36.2	37.5	37.5	48.8	37.5	37.3	36.0	33.0	32.7	25.7	26.7	23.6	
EXTERNAL SOLVENCY INDICATORS (in %)														
External debt/GDP	59.3	58.5	59.0	62.3	72.7	79.0	72.2	80.9	74.8	77.1	78.5	77.9	77.8	
Short-term debt/GDP	13.2	13.9	13.1	14.9	15.7	17.6	12.0	14.5	12.1	10.0	11.1	10.6	10.6	
External debt/exports of goods and services	234.9	205.7	214.3	218.9	276.9	247.1	216.5	223.6	184.0	177.7	168.2	160.9	157.2	
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	250.2	238.5	220.1	211.7
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	199.9	196.6	193.7	208.7	200.7	211.5
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	70.8	77.4	80.1	82.6	69.0	79.8	82.7	89.8	92.6	97.7	103.1	112.6	115.2	107.3
MEMORANDUM: (in EUR million)														
GDP [1]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,319	33,491	7,514	8,237	8,685 [2]
External debt	12,520	14,291	17,382	20,982	22,272	23,509	24,123	25,645	25,644	25,679	26,294	25,825	25,820	
External debt servicing	1,054	2,513	3,039	3,594	3,922	3,564	4,154	4,130	4,594	4,731	4,021	1,055	1,034	
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	10,378	9,501	9,291	9,552
Short-term debt [3]	951	968	1,044	1,832	1,852	1,758	612	455	196	99	305	345	332	
Current account balance	-1,778	-2,356	-5,474	-7,125	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-1,577	-369	-272	-240
CREDIT RATING (change of rating and outlook)	2005 July/May	2006 Feb	2007 July	2008 March/Dec	2009 Dec	2010 Nov	2011 March	2012 Aug	2013 July	2014 Jan	2015 Dec	2016 Jan/March	2016 June	
S&P	BB- /stable	BB- /positive	BB- /stable	BB- /negative	BB- /stable		BB /stable	BB- /negative				BB- /stable		
Fitch	BB- /stable			BB- /negative		BB- /stable		BB- /negative		B+ /stable	B+ /positive		BB- /stable	
Moody's									B1 /stable			B1 /positive		

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 – 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 BPM 6. Data for 2005 and 2006 are shown according to BPM 5.

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 488.3 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 995.4 mln, of which EUR 433.7 mln relates to domestic banks and EUR 561.7 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	2015	Q1 2016	Q2 2016	Q3 2016
Real GDP growth (in %)[1]	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1.0	2.6	-1.8	0.8	3.8	2.0	2.5
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	1.7	1.5	0.6	0.3	0.6
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	10,378	9,501	9,291	9,552
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	15,631	3,946	4,375	4,390
- 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	8.2	11.8	9.3	8.4
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	18,899	4,516	5,111	4,931
- growth rate in % compared to a year earlier	0.7	24.5	-	18.1	-28.3	8.7	15.7	3.1	4.7	1.8	4.4	1.7	7.4	4.3
Current account balance[3]														
(in EUR million)	-1,778	-2,356	-5,474	-7,125	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-1,577	-369	-272	-240
as % of GDP	-8.4	-9.6	-18.6	-21.1	-6.6	-6.8	-10.9	-11.6	-6.1	-6.0	-4.8	-4.9	-3.3	-2.8
Unemployment according to the Survey (in %)	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	19.2[7]	17.7	19.0	15.2	
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	368.0	353.7	378.5	373.6
RS budget deficit/surplus (in % of GDP)[4]	0.5	-1.7	-1.6	-1.7	-3.2	-3.4	-4.0	-5.9	-5.2	-6.3	-2.8	-1.0	0.5	2.9
Consolidated fiscal result (in % of GDP)[4]	1.2	-1.5	-1.9	-2.6	-4.4	-4.6	-4.8	-6.8	-5.5	-6.6	-3.7	-1.7	-0.2	1.3
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	70.4	74.7	71.5	71.0	70.8
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	108.85	111.37	109.02	110.44
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	111.25	108.60	111.07	109.90
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	120.73	122.87	123.02	123.29
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	121.63	122.92	123.31	123.29
MEMORANDUM:														
GDP (in EUR million)[5]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,319	33,491	7,514	8,237	8,685[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 and 2015 according to the 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 for public debt: MoF.

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Executive Board meetings and changes in the key policy rate

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	4.50	0

2016

Date	Key policy rate (p.a, in %)	Change (in basis points)
12 January	4.50	0
11 February	4.25	-25
17 March	4.25	0
7 April	4.25	0
17 May	4.25	0
9 June	4.25	0
7 July	4.00	-25
11 August	4.00	0
8 September	4.00	0
13 October	4.00	0
10 November	4.00	0
8 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 8 September 2016

At its meeting today, the NBS Executive Board decided to keep the key policy rate unchanged at 4 percent.

In making that decision, the Executive Board was guided by the effects of past rate cuts and the inflation outlook for the period ahead. As the Executive Board assessed, the return of year-on-year inflation within the target tolerance band in the first half of 2017 will be led primarily by the gradual increase in aggregate demand at home and inflation abroad, as well as by the low-base effect of petroleum product prices, while low food production costs will continue to hold inflation back for some time to come.

The Executive Board also took into consideration persistent uncertainties in the international commodity and financial markets and their potential impact on inflation and capital flows to emerging market economies.

However, the resilience of the Serbian economy to external shocks has increased, reflecting consistent implementation of fiscal consolidation measures and structural reforms. Owing to this, fiscal imbalances have narrowed down, while Serbia's macroeconomic prospects have improved significantly, as confirmed by the IMF in the fourth and fifth reviews of the arrangement.

The next rate-setting meeting of the Executive Board is scheduled for 13 October.

Press release from Executive Board meeting held on 13 October 2016

At its meeting today, the NBS Executive Board decided to keep the key policy rate unchanged at 4 percent.

In making the decision, the Executive Board took into consideration that inflation is expected to return within the target tolerance band towards mid-2017, led by the effects of past monetary easing and higher demand at home, as well as by a gradual recovery in global oil prices and inflation abroad. On the other hand, the disinflationary impact of a further drop in prices of primary agricultural commodities and the resulting low food production costs owing to a good agricultural season will be felt for some time to come.

The Executive Board advised caution in the conduct of monetary policy bearing in mind uncertainty in the international financial markets regarding future FED and ECB measures and their potential impact on global capital flows. However, the successful implementation of fiscal consolidation and structural reforms, as well as the reduction of external imbalances, have strengthened the resilience of the domestic economy to potential adverse influences from the international environment. This is also confirmed by a sizeable drop in the country's risk premium to its nine-year low.

The next rate-setting meeting of the Executive Board is scheduled for 10 November.

Press release from Executive Board meeting held on 10 November 2016

At its meeting today, the NBS Executive Board decided to keep the key policy rate unchanged at 4.0 percent.

In making the decision, the Executive Board took into consideration the inflation projection and the effects of past monetary easing on inflation movements in the period ahead, as well as the fact that the inflation target for 2017 has been revised to 3.0% ± 1.5 percentage points on account of the substantial improvement in macroeconomic performances and prospects. It is expected that year-on-year inflation will rise gradually in the coming months, return within the new target tolerance band early next year and move within the band thereafter.

Such movements in inflation are anticipated based on the effects of past monetary easing and the recovery of demand at home, coupled with a gradual increase in global oil prices and inflation abroad. On the other hand, the disinflationary impact of a further drop in prices of primary agricultural commodities at home and abroad owing to a good agricultural season, and the resulting low food production costs, will continue to be felt for some time to come.

As highlighted by the Executive Board, monetary policy caution is mandated by uncertainties in the international financial market concerning future measures of the Fed and ECB, and their potential impact on global capital flows. However, successful implementation of fiscal consolidation and structural reforms, including the narrowing of external imbalances, increase the resilience of the domestic economy to potentially adverse effects from the international environment. This is confirmed by the IMF's positive assessment following their October visit, a falling country risk premium and progress on international competitiveness rankings based on the improvement of the country's business and investment climate.

The NBS Executive Board adopted the November Inflation Report, which will be presented to the public on Monday, 21 November. On that occasion, monetary policy decisions and the underlying macroeconomic developments will be explained in detail.

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

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