National Bank of Serbia

November 2018

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 8 November 2018.

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

ABBREVIATIONS

bn – billion
bp – basis point
CPI – Consumer Price Index
EBRD – European Bank for Reconstruction and Development
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
FOMC – Federal Open Market Committee
GDP – gross domestic product
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
LHS – left hand scale
mn – million
NAVA – non-agricultural value added
NPL – non-performing loan
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
RMCP – real marginal cost of processed food production
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.

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I Overview

Economic indicators still point to stable **global economic growth**, but the outlook has been mildly downgraded since the last Report, so now the pace of growth expected this and the coming year is the same as in 2017 (3.7%). Growth in the euro area, our most important trade partner, continued in 2018, though at a slightly slower pace than in 2017, mainly due to somewhat weaker external demand which led to a downward revision of the euro area growth for this and the coming year. Economic growth outlook of Southeastern Europe was also slightly downgraded, while the growth forecast for Serbia was revised upward by all relevant international institutions. Since the beginning of 2018, under the influence of rising global oil prices, **global inflation** has trended higher, though staying moderate in the majority of countries. Similar trends are expected in the period ahead. The leading central banks proceeded with monetary policy normalisation, while global financial conditions, though still favourable, have tightened, which is associated also with trade and geopolitical tensions.

Developments in the international environment since the last Inflation Report are characterised by somewhat weaker than expected global growth outlook, moderate global inflation, and a mild tightening in financial conditions which reflects further monetary policy normalisation of the Federal Reserve System.

Domestic macroeconomic conditions in which the monetary policy is pursued remained favourable, as evidenced by the main macroeconomic indicators. Inflationary pressures stayed low even against the background of strong economic growth. **Staying within the target tolerance band** during Q3, **y-o-y inflation** came at 2.1% in September, with more than half of the contributions coming from two groups – petroleum products and fruit and vegetables. This shows that inflationary pressures are basically still low, as confirmed by the low and stable core inflation which in Q3 moved at around 1% y-o-y, and by inflation expectations of the financial and corporate sectors anchored at the target midpoint for both one and two years ahead. Anchored inflation expectations of the financial and corporate sectors indicate that monetary policy is credible and that higher prices of petroleum products and unprocessed food had no second-round effects on other prices.

Consistent with our expectations, y-o-y inflation continued to move within the target tolerance band. Inflationary pressures on account of the majority of factors remain low, as confirmed by core inflation of around 1% y-o-y and inflation expectations anchored around the target midpoint of 3%.

In setting the **key policy rate** in the period since the last *Inflation Report* the NBS Executive Board took into account inflation movements in the next two years, i.e. over the inflation projection horizon, which are expected to remain within the target tolerance band, and the effects of past monetary policy easing, which helped economic growth accelerate to the highest rate in the last ten years. Caution in the conduct of monetary policy was mandated

Since April this year the key policy rate has been kept unchanged at 3%, its lowest level in the inflation targeting regime.

primarily by the uncertainty in international commodity and financial markets. Global oil prices picked up and their movement going forward is uncertain. The leading central banks – the Federal Reserve System and the European Central Bank are expected to further normalise their monetary policies. Caution was advised also due to rising protectionism in international trade between the major world economies. Still, the Executive Board pointed out that the resilience of the Serbian economy to potential adverse effects from the international environment has increased owing to favourable macroeconomic indicators and outlook for the period ahead.

Lending activity rose (by 7.7% y-o-y in September) led by both supply and demand side factors. Owing to the rise in lending and NPL resolution activities, the share of NPLs in total loans continued to slide, dropping to 6.4% in September, its lowest level since 2008 when this indicator of bank portfolio quality was introduced.

Thanks to past monetary policy easing, low country risk premium and persistently low interest rates in the international money market, **the private sector and the government enjoy favourable financing conditions**. This is evidenced by interest rates on new dinar corporate and household loans, which in Q3 moved close to the minimum recorded in previous months. Along with the effects of growing economic activity, accompanied with a labour market recovery and increased interbank competition, this contributed to further **growth in lending**. Such conclusions are also supported by the estimates of banks presented in the NBS lending survey. In banks' view, factors behind the lending growth are more favourable credit conditions and increasing credit demand. Despite NPL resolution efforts which led to sizeable write-offs and sale, the y-o-y growth of total loans (excluding the exchange rate effect) stepped up since the start of the year, to 7.7% in September (11.9% y-o-y excluding the effects of NPL write-off and sale). That the NPL Resolution Strategy continued to yield excellent results is indicated also by the data which show that in little more than three years after its adoption, the amount of NPLs shrunk by more than 67% and their share in total loans by close to 16 pp, to 6.4% in September. This is the lowest level since 2008, when this indicator of bank portfolio quality was introduced.

Thanks to successful fiscal consolidation and full coordination of monetary and fiscal policies, which led to a budget surplus and brought public debt within sustainable limits – the fiscal policy is increasingly supportive of economic growth. The rise in government capital expenditure boosts investment, and higher public sector wages and pensions are one of the sources of consumption growth, while not causing any major inflationary pressures.

Even against the background of a significant rise in government capital expenditure, **the consolidated government budget continued to record a surplus** which in the year to August came at RSD 41.1 bn. Excluding interest expenses, the primary surplus amounted to RSD 123 bn. The consolidated revenue rose by 3.4% y-o-y primarily on the back of expanded domestic demand and positive trends in the labour market, while expenditure grew by 6.9%, mainly due to higher capital expenditure. Interest payments decreased further amid lower financing needs of the government, as well as the effects of past monetary policy easing and the

decline in the country risk premium. At end-September, public debt of the central government equalled EUR 23.9 bn and its share in projected GDP 55.9% (compared to 57.9% at end-2017). The dinar share of debt rose from 23.0% at end-2017 to 25.9% in September 2018 as a result of the government's reorientation to domestic borrowing through the issuance of long-term dinar securities in the local market, with a view to further reducing the currency risk and strengthening public debt sustainability.

High growth rates of manufacturing exports endured (9.8% y-o-y), while the rise in imports (13.1% y-o-y) resulted mainly from increased needs of corporates for equipment and intermediate goods, reflecting the current investment cycle.

Current account movements in the first nine months of 2018, compared to the same period last year, are characterised by the higher deficit on trade in goods, which is mainly offset by the higher surplus on the trade in services and secondary income accounts, as well as the lower primary income deficit. Manufacturing exports continued to grow at relatively high rate, driven by the rising exports of almost all branches, despite the softening of external demand from the euro area. At the same time, the ongoing investment cycle, also spurred by inflows of foreign direct investment, supported the growth in imports of equipment and intermediate goods for industrial purposes, which proved to be the main driving force behind overall import growth. Imports were also pushed up by higher global oil prices. In the **financial account**, since the start of the year, the net capital inflow amounted to EUR 2.2 bn, notably as a result of the project-diversified inflow of FDI, channelled primarily to tradeable sectors. This inflow, worth EUR 1.8 bn net (up by 3.2% y-o-y) more than fully covered the current account deficit (122.3%). As in the previous three years, we expect that the net FDI inflow will ensure full coverage of the current account deficit this year as well. This trend is likely to continue in the coming period, acting as one of the factors of external sustainability in the medium run.

Despite a softening external demand growth, primarily in the euro area, domestic factors provided a strong push to economic growth, which in the first half of the year exceeded our expectations and maintained a robust pace in Q3 as well.

In the first half of the year, **GDP growth** exceeded expectations stated in the previous *Report*, and was 4.9% higher y-o-y. According to the first estimate of the Serbian Statistical Office, a vigorous pace of growth was kept in Q3 as well (3.7% y-o-y). Despite the slowdown in external demand growth, notably in the euro area, domestic factors (past investment, infrastructure projects, enhancement of the business environment, favourable financial conditions and positive labour market trends) lent a strong impetus to economic growth. The highest contribution to growth in Q3 continued to come from service sectors, which were positively affected by the recovery of domestic demand, and construction, owing to further implementation of infrastructure projects and gradual recovery of the real estate market. Q3 also saw an

excellent agricultural output, as suggested by the published preliminary data on autumn crops yields. Manufacturing was another positive contributor, while total industry had a negative impact due to the overhaul of the energy sector and low rivers, which is why production in mining and energy declined temporarily. The continuous s-a GDP growth extended into the fourteenth consecutive quarter and, according to our estimate, stood at 0.3% in Q3.

Serbia's business and investment environment improved, as confirmed by progress in the areas monitored in the context of international competitiveness assessments.

That **Serbia's business and investment environment got better** is also confirmed by the latest World Economic Forum's Global Competitiveness Report 2018 according to which Serbia improved its competitive position for the third year in a row, currently holding the 65th place in the group of 140 countries. As in the year before, progress was achieved within macroeconomic environment indicators and reflects low and stable inflation, a public debt reduction and an improved credit rating of the country. Serbia achieved considerable progress also in the context of financial system indicators, owing primarily to a sharp reduction in the NPL share in total loans, high capital adequacy and greater availability of funding for SMEs. According to the latest World Bank's Doing Business report, Serbia continued to get closer to the best international practice – it increased its score compared to the previous year, and still ranks among the top 50 countries in terms of the ease of doing business (of total 190 countries), though its 48th position is, in relative terms, slightly more unfavourable.

The labour market is marked by formal employment gains, a reduction in unemployment to the lowest level in the last quarter of a century and rising wages.

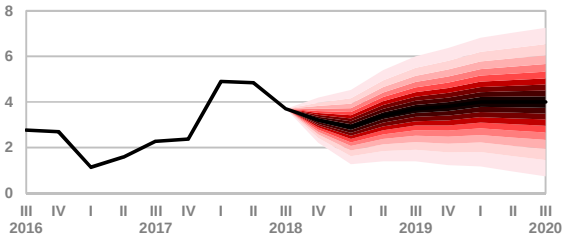
Robust economic growth, through rising demand for labour force, contributes to further **recovery of the labour market**, which features rising employment, a reduction in unemployment numbers in all occupational groups, and increasing wages. As in previous quarters, formal employment growth in Q3 was driven by higher employment in the private sector, while the public sector continued with the downsizing process. In terms of activity, compared to 2017, formal employment increased the most in manufacturing. With the economy growing faster than employment numbers, productivity gains of the overall economy are recorded. Unemployment is at its lowest level in the last quarter of a century.

We raised the GDP growth forecast to 4.2% for this year, while keeping it unchanged for 2019 (3.5%), owing partly to the high base on account of faster growth this year.

Faster than estimated growth in construction and agriculture on the production side, and investment growth on the expenditure side (assessed as upside risks in the August projection as well), led us to **revise upward the GDP growth forecast** for 2018 to 4.2%, from 4% in August. We did not change the growth forecast for 2019 (3.5%), in part due to the high base on account of faster growth this year. We also anticipate that continued

reforms will underpin sustainable GDP growth dynamics of around 4% in the medium term. We estimate that this and next year's GDP growth will be driven by domestic demand, i.e. investment and household consumption. A favourable macroeconomic environment and growth outlook, continued intensive investment in infrastructure and favourable financial conditions should continue to prop up investment. Also, favourable terms of financing, a further rise in disposable income on account of expected further growth in wages and employment, and gradual recovery of consumer confidence, will lead to further expansion of household consumption. Exports are also expected to be a positive contributor, owing to the continued vibrant growth in manufacturing exports. However, the contribution of net exports is likely to remain negative in 2018 as well, due to faster growth in imports, notably of equipment and intermediate goods, including consumer goods to an extent. In 2019, export growth is likely to outpace imports, reflecting past investment, rising external demand and high export inventories of agricultural goods following an excellent season. The risks to the economic growth projection are assessed to be symmetric and are associated primarily with developments in the international environment, i.e. the pace of growth of the euro area and our other important trade partners, as well as developments in the international commodity and financial markets.

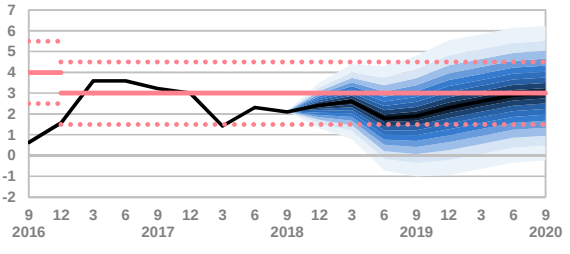
GDP growth projection
(y-o-y rates, in %)



Under the **November central projection, which is almost unchanged from August**, y-o-y inflation is expected to remain low and stable in the next two years. It will continue to move within the target tolerance band – most probably below the target midpoint until end-2019, trending temporarily closer to the midpoint in the first months of that year due to the low base effect. The main medium-term inflation factor will be aggregate demand. Disinflationary pressures from past appreciation of the dinar will also gradually weaken in the coming period. In the short term, low costs of food production will have a disinflationary effect, and next year inflation will be dragged down by this year's high base of fruit and vegetables and petroleum products. Working in the opposite direction will be the assumed administered price growth of 4%. The risks to the projected inflation path are symmetric and relate primarily to future developments in the global commodity and financial markets, and to a degree, administered price growth at home.

According to our new central projection as well, y-o-y inflation will remain low and stable, moving within the target tolerance band (3.0±1.5%) until the end of the projection horizon. In 2019, it will most probably stay below the target midpoint.

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



Looking ahead, **monetary policy decisions** will continue to depend on the assessment of the impact of inflation factors from the domestic and international environment. As the key risks emanate from the international environment, the NBS will continue to closely monitor

We estimate that the key risks in the coming period emanate from the international environment and, as such, may affect the monetary policy stance.

and analyse movements in the international financial market and the market of primary commodities, notably crude oil and primary agricultural commodities, and will assess their impact on economic developments in Serbia. As so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium term which will, together with maintaining financial stability, contribute to sustainable economic growth and strengthen the country's resilience to external uncertainties.

II Monetary policy since the August *Report*

Since the August Inflation Report, the key policy rate was kept at 3.0%. In deciding not to change the key policy rate, the NBS Executive Board considered the outlook for inflation and its underlying factors, as well as the effects of past monetary policy easing. According to the Executive Board's estimate, inflation will continue to move within the target tolerance band in the next two years, the period for which inflation is projected, probably staying below the 3% target by end-2019.

The Executive Board assessed that the effects of past monetary policy easing, coupled with a high level of confidence in the central bank's commitment and ability to maintain inflation low and stable, are contributing to the strong performance of the Serbian economy, which has been growing since the beginning of the year at the highest growth rate in the last ten years. Investments continue to grow, underpinned by favourable financing conditions, as well as by the FDI inflow, which more than fully covers the current account deficit and supports its reduction in the medium run, through impact on export growth.

Caution in the conduct of monetary policy was still warranted primarily by uncertainties in the international environment. Global oil prices picked up and their movement going forward is uncertain. Also, leading central banks are expected to further normalise their monetary policies, which, in the scenario of rising protectionism in global trade and consequently higher uncertainty in the international financial market, could affect capital flows to emerging economies. Still, the Executive Board repeatedly stressed that the resilience of the Serbian economy to potential adverse effects from the international environment has increased owing to favourable macroeconomic indicators and prospects.

Since the August *Report*, the NBS Executive Board kept the key policy rate at 3%, its lowest level yet in the inflation targeting regime. The decision to keep the rate on hold was based on the August projection, which predicted that inflation would continue to move within the target tolerance band in the next two years – below the target midpoint by end-2019, though temporarily approaching it in the first months of 2019 owing to the low base effect. The main drivers of inflation in the medium run, according to the Executive Board's estimate, will be the rising aggregate demand and gradual waning of disinflationary pressures on account of the dinar's past appreciation. In the short term, low costs of food production will have a disinflationary effect, while administered prices will work in the opposite direction. Uncertainty surrounding the August inflation projection related primarily to movements in the international commodity and financial markets and, to an extent, administered price growth at home.

Regarding economic activity, GDP growth projection for this year was raised in August by 0.5 pp, to around 4%. The upward revision was a result of faster than expected construction and agriculture growth on the production side, and faster investment growth on the expenditure side. The GDP growth forecast for 2019 remained unchanged (3.5%), in part due to the high base. Continued implementation of reforms is expected to serve as the basis for sustainable GDP growth of around 4% in the medium run.

In Q3, inflation moved in line with the August projection and equalled 2.1% y-o-y in September. In addition, the contribution of unprocessed food was lower than assumed in August, with greater contribution to y-o-y inflation coming from petroleum products due to continued rise in global oil prices. At the same time, core inflation was low and stable (1.1% y-o-y in September), signalling persistently low inflationary pressures. Subdued

inflationary pressures were also indicated by the one-year and two-year ahead inflation expectations of financial and corporate sectors anchored around the 3% target.

In keeping the key policy rate on hold, the Executive Board was guided by the expectation that future inflation movements would reflect to a large extent the gradual rise in domestic demand which is supported also by the effects of past monetary policy easing. Economic growth, at the highest rate in the last ten years, will contribute to the weakening of disinflationary pressures on that account and to the gradual closing of the negative output gap. The Executive Board announced in October that economic growth this year is likely to exceed 4%, meaning that since the beginning of the year domestic demand has been rising somewhat faster than estimated in the August inflation projection.

Particularly prominent is the investment growth, supported by favourable business environment, infrastructure projects and the rise in lending activity. The rise in lending activity is underpinned by the past monetary policy easing, as well as by greater interbank competition, low country risk premium and low interest rates in the euro area money market. As assessed by the Executive Board, high and project-diversified FDI inflow and the implementation of infrastructure projects should continue to provide a positive impetus to investment, which will remain one of the drivers of economic growth. Also, government capital investment went up by almost 70% in real terms in the first eight months of the year compared to the same period last year.

Domestic demand growth is also supported by household consumption, primarily owing to favourable developments in the labour market – growth in wages and employment, elevated participation rate and the fall in unemployment rate close to its Q2 2017 low. In addition, the growth in pensions and the expected increase in public sector wages will additionally spur household demand. Higher disposable income of households also reflects lower interest rates and consequently, lower credit costs, which are attributable to past monetary policy easing.

The Executive Board also took into account that this year's budget performance will be better than planned by the Fiscal Strategy. This will enable continued downward trend in the share of public debt in GDP, which should positively affect the country risk premium and credit rating. Together with high FDI inflow, which more than fully covers the current account deficit and contributes to its reduction in the medium run, this will buttress relative stability in the FX market.

The Executive Board stated that the past strengthening of the dinar exerted a disinflationary effect through lower dinar import prices, but that the disinflationary pressures on this account will gradually diminish in the coming period. However, given the expected moderate price growth in the euro area, our most important trade partner, the Executive Board pointed out that the rise in dinar-denominated import prices is likely to stay relatively low.

The Executive Board expected not only further recovery of domestic, but also of external demand. Economic growth of the euro area and the Central and Southeast European region should provide a positive impetus to exports, primarily manufacturing exports, and thus, help sustain high export growth rates in the period ahead. However, caution was mandated by the risk of trade tensions and the possible negative effects not only on global and euro area growth, but also on volatility in commodity and financial markets.

Global commodity markets were plagued by uncertainty, primarily in respect of movements in the prices of oil, which reached USD 86 per barrel in October, on average up by 40% y-o-y. Even though, according to futures, global oil prices are not poised for further growth, but rather for stabilisation by end-2018 and a mild decline by end-2019, the Executive Board underscored that caution is necessary in this regard.

In addition, leading central banks, the Fed and the ECB, proceeded with gradual monetary policy normalisation. After the June rise, the Fed raised its target range for the federal funds rate again in September, to 2.00–2.25%, while the ECB confirmed its June decisions to implement the asset purchase programme at the reduced monthly pace of EUR 15 bn from October until end-2018 ending the programme thereafter, and to keep its key policy rate unchanged at least through the summer of 2019. Unchanged policy rate and the ECB's announcement that it would continue to reinvest the principal payments from maturing securities even after completing the asset purchase programme should contribute to favourable financing conditions in the euro area.

The Executive Board exercised caution in monetary policy decision-making also due to rising protectionism in global trade which dampened investor sentiment and heightened uncertainty in the international financial market. Still, the Executive Board pointed out that the resilience of the

Serbian economy to potential adverse effects from the international environment has increased, owing to more favourable macroeconomic indicators and prospects.

Based on the new projection, which is almost unchanged from August, the Executive Board decided in its November meeting to keep the key policy rate unchanged. Having estimated that the key risks in the implementation of monetary policy come from the international environment, the Executive Board stressed that trends in the international financial and primary commodity markets, especially of markets of crude oil and primary agricultural commodities, will continue to be closely monitored and analysed. As before, monetary policy will be predictable and consistent in achieving low and stable inflation in the medium run, which, along with preserving financial stability, will contribute to sustainable economic growth and strengthening of the country's resilience to external uncertainties.

III Inflation movements

Moving within the target tolerance band during Q3, y-o-y inflation came at 2.1% in September, with more than half of inflation growth being attributable to two groups of prices only – the prices of petroleum products and fruit and vegetables. This points to the still low inflationary pressures, also confirmed by the low and stable core inflation and the inflation expectations of the financial and corporate sectors which are anchored within the target band.

Inflation movements in Q3

Inflation continued moving within the target tolerance band during Q3, measuring 2.1% y-o-y in September. As in most countries in the international environment, the greatest contribution to y-o-y inflation in September came from the prices of petroleum products and fruit and vegetables (1.2 pp, taken together). The quarterly dynamics of y-o-y inflation was determined by fruit and vegetable prices, as well as the prices of fresh meat which are at the same time the main reason why inflation turned out lower at end-Q3 than at end-Q2. Processed food and other industrial products also provided a smaller contribution to inflation than they did in June. Low inflationary pressures are further indicated by the low and stable core inflation, which in Q3 amounted to 1.0% on average, consistent with the expectations stated in the August *Report* and developments since the beginning of the year.

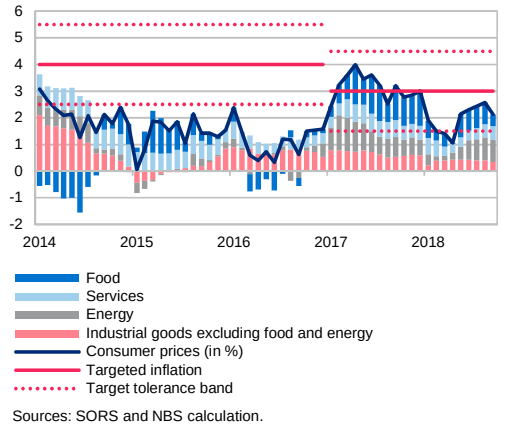
Table III.0.1 **Contribution to y-o-y consumer price growth**
(in pp)

	2018		Difference
	June	Sept.	
Consumer prices (CPI)	2.3	2.1	-0.2
Unprocessed food	0.5	0.3	-0.2
Fruit and vegetables	*0.7*	*0.5*	*-0.2*
Fresh meat	*-0.1*	*-0.2*	*-0.1*
Processed food	0.2	0.1	-0.1
Industrial products excluding food and energy	0.4	0.3	-0.1
Energy	0.7	0.8	0.1
Petroleum products	*0.4*	*0.6*	*0.2*
Services	0.4	0.5	0.1

Sources: SORS and NBS calculation.

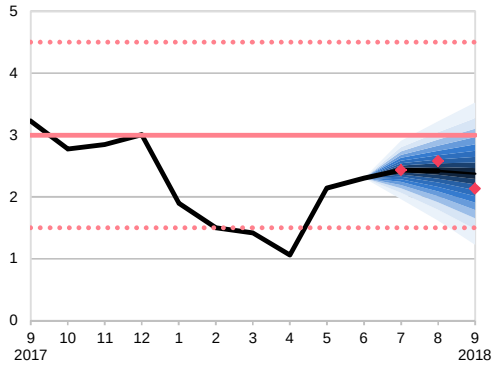
Consumer prices fell by 0.3% in Q3, which is somewhat more than anticipated at the time of the August *Report*. The decline in consumer prices was driven most by the prices of **food and non-alcoholic beverages** (-0.6 pp). The 4.3% fall in **unprocessed food** prices largely reflects the cheapening of fresh vegetables by 11.1% (-0.5 pp contribution to inflation), which was sharper than expected, and the fall in prices of fresh fruit (0.6%), which was unusual for this time of the year. **Processed food** prices also fell mildly (0.5%, - 0.1 pp contribution), mainly in response to lower costs of food production caused by the decline in domestic prices of primary agricultural commodities. A positive contribution to inflation came from the rise in the prices of fresh meat (0.2%), though this rise was lower than typically recorded in this period of the year.

Chart III.0.1 **Contribution to y-o-y consumer price growth**
(in pp)



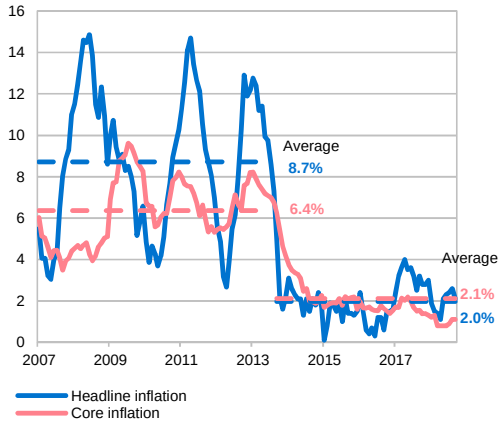
Sources: SORS and NBS calculation.

Chart III.0.2 **Short-term inflation projection from August 2018 and actual inflation**
(y-o-y rates, in %)



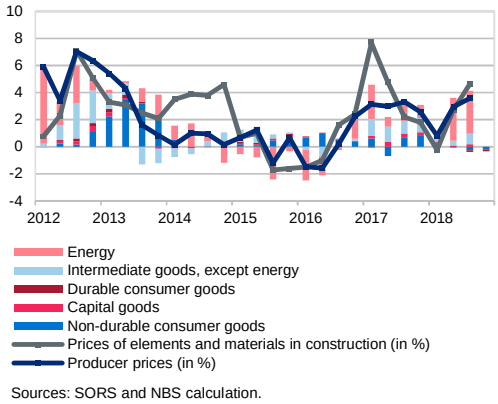
Sources: SORS and NBS calculation.

Chart III.0.3 **Headline and core inflation**
(y-o-y rates, in %)



Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

* Industrial producer prices for the domestic market.

Energy prices increased slightly in Q3 (0.7%), mostly owing to the rise in **petroleum product prices** (1.3%, 0.1 pp contribution) which mirrored movements in global oil prices. A 1.1% increase in the prices of solid fuels (coal and firewood) worked in the same direction, providing a negligible contribution to inflation.

Quarterly inflation was also under the impact of an increase in the prices of **services** (0.7%, 0.2 pp contribution). The said increase is a result of the rise in prices of vehicle maintenance and use services by 6.9% (i.e. technical inspections of vehicles) and prices of rents by 4.5%, each providing a 0.1 pp contribution to inflation.

Industrial product prices excluding food and energy remained almost unchanged in Q3. The adjustment of cigarette prices in July (3.9%, 0.2 pp contribution) was neutralised by the seasonal decline in the prices of clothes and footwear (each contributing -0.1 pp) and lower prices of audio and TV devices. Y-o-y, the growth in industrial product prices slowed down from 1.6% in June to 1.2% in September.

The prices within core inflation (excluding energy, food, alcohol and cigarettes) **almost stagnated during Q3**. On the one hand, there was a seasonal decline in prices of clothes and footwear and a fall in the prices of audio and TV devices, and on the other, a rise in the prices of vehicle maintenance and repair services and rents. Observed at y-o-y level, core **inflation remained low and stable**, moving only slightly up – from 1% in July and August to 1.1% in September.

Administered prices went up in Q3 by 1.1% (0.2 pp contribution), almost entirely due to the increase in excise duties on cigarettes in July. Their y-o-y growth was the same as at the end of the previous quarter – 2.9%..

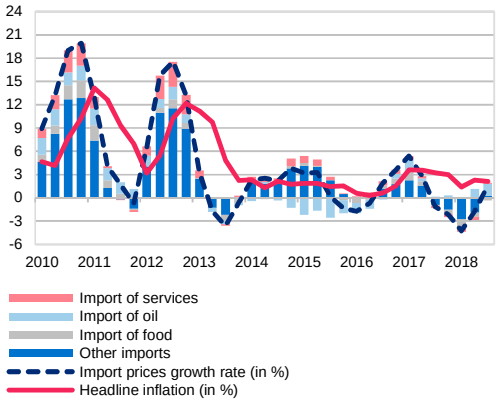
Producer and external prices

Industrial producer prices in the domestic market continued up, ending Q3 with a y-o-y growth of 3.6%. As in the previous quarter, the strongest contribution to their growth came from the higher **prices in energy production** (around 3.2 pp contribution), due to the increase in the domestic prices of crude oil and petroleum products. The prices of **intermediate goods** also went up owing to a rise in metal product prices, as did the prices of **capital goods** due to higher prices of construction material. The reduction in the prices of **durable consumer goods** and **non-durable consumer goods** worked in the opposite direction, driven by the lower costs in food production. The **prices of elements**

and materials incorporated in construction rose in Q3 by 4.6% y-o-y, in part due to the low base effect.

Import prices expressed in dinars[1] stagnated in Q3. On the one hand, global oil prices expressed in USD continued up in Q3, and were around 1.1% higher than in Q2 on average, due to reduced supply and ongoing trade and geopolitical tensions. The prices of German exports, used to approximate prices of imported equipment and intermediate goods, went up (0.2%), as did the consumer prices in the euro area, which are used to approximate prices of service imports. On the other hand, global prices of food expressed in USD fell by 4.2%, which neutralised, to the greatest extent, the growth in prices of other import components at quarterly level. After being in the negative territory four quarters in a row, in Q3 import prices expressed in dinars rose on average by 1.6% y-o-y.

Chart III.0.5 **Contribution of individual components to y-o-y growth rate of import prices in dinars**
(in pp)



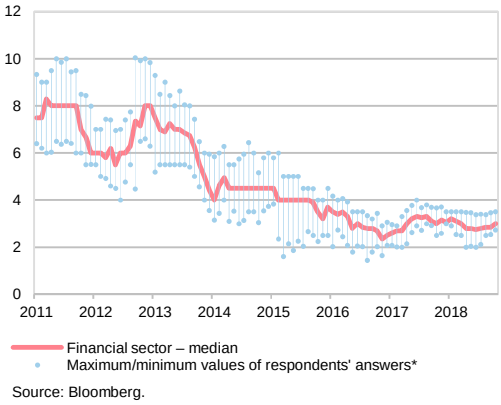
Sources: Destatis, FAO, Bloomberg, Eurostat, SORS and NBS calculation.

Inflation expectations

The financial and corporate sectors expect that achieved price stability will be preserved over medium run. Their one-year and two-year ahead inflation expectations anchored around the 3% target are a reflection of their confidence in the measures taken by the NBS and indicate higher credibility of monetary policy for some time now.

According to the Ipsos survey results, the **financial sector** expects y-o-y inflation in Q3 2019 to move around 3.0%. Lower y-o-y inflation outcome in September drove the expectations in October down to 2.8%. The Bloomberg survey results point to similar conclusions that one-year ahead inflation expectations of the financial sector in Q3 have ranged between 2.8% and 3.0% (in October and November). Looking at the longer horizon, the financial sector expects price stability and inflation movements to be within the NBS target tolerance band for five years now (since October 2013). Better anchoring of inflation expectations is also suggested by the significantly lower dispersion of individual expectations of financial sector representatives.

Chart III.0.6 **One-year ahead inflation expectations of the financial sector**
(y-o-y rates, in %)

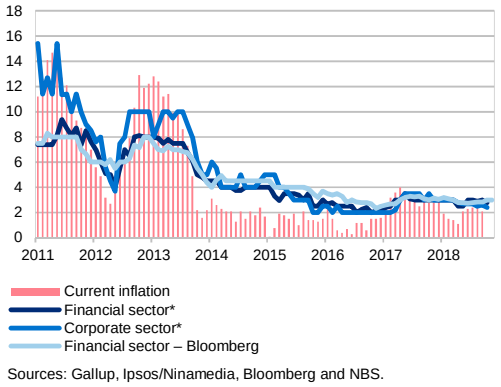


Source: Bloomberg.

* 10-90 percentile range.

According to Ipsos survey results, one-year ahead **inflation expectations of the corporate sector** are low, stable and anchored. They were lowered from 2.7% at end-Q2 to 2.4% in October.

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

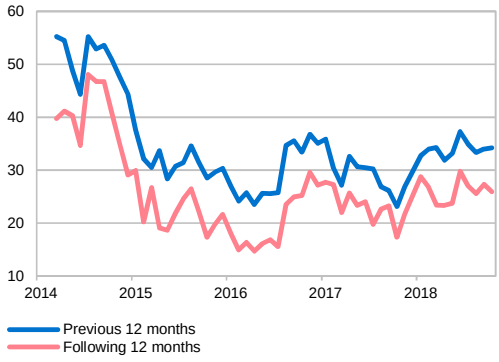


Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.

* Ipsos and Gallup agencies until December 2014, Ninamedia agency since December 2014, and Ipsos agency since January 2018.

[1] The weighted average of the global oil price and food price index (FAO index), euro area consumer prices, and export prices of Germany, one of Serbia's main foreign trade partners, is used as an indicator of import prices.

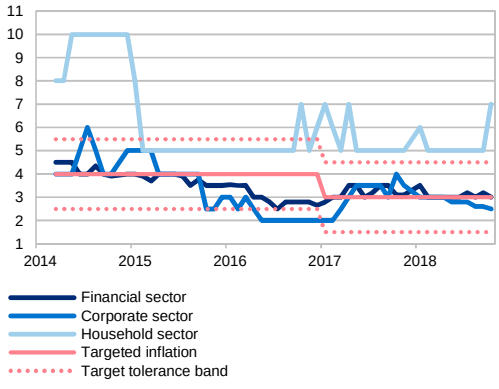
Chart III.0.8 **Household perceived and expected inflation***
(in index points)



Sources: Ipsos/Ninamedia and NBS.

* Ipsos agency until December 2014, Ninamedia agency since December 2014, and Ipsos agency since January 2018.

Chart III.0.9 **Two-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Ipsos/Ninamedia and NBS.

* Ipsos agency until December 2014, Ninamedia agency since December 2014, and Ipsos agency since January 2018.

Inflation expectations of the household sector are typically higher and more volatile than those of other sectors. One-year ahead expectations of the household sector in Q3 ranged from 5% to 7%. They rose to 8% in October, probably on the back of media reporting on meat, vegetable and petroleum product price hikes. On the other hand, according to the results of the qualitative survey, the perceived inflation index is still higher than the expected inflation index, which means that households expect lower inflation in the upcoming 12 months compared to the past 12 months[2].

Two-year ahead inflation expectations of the financial sector are anchored within the NBS target tolerance band since their monitoring began (March 2014), ranging from 3.0% to 3.2% in Q3. Medium-term expectations of the corporate sector were somewhat lower, as they fell from 2.8% in July to over 2.6% in August and September, and further down to 2.5% in October. Two-year ahead inflation expectations of the household sector were stable at 5.0% from February, but rose to 7% in October.

Preserved price stability in the past five years and the confidence of the financial and corporate sectors in the measures taken by the NBS contribute positively to the expectations regarding economic growth. Additionally, optimism regarding the improvement of business conditions rose relative to Q2. At the same time, the number of citizens expecting a rise in the standard of living over the next 12 months also went up.[3]

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

[3] The net percentage of the population expecting a rise in the standard of living over the next 12 months equalled 11.5% at end-Q2 compared to 15.5% at end-Q3.

IV Inflation determinants

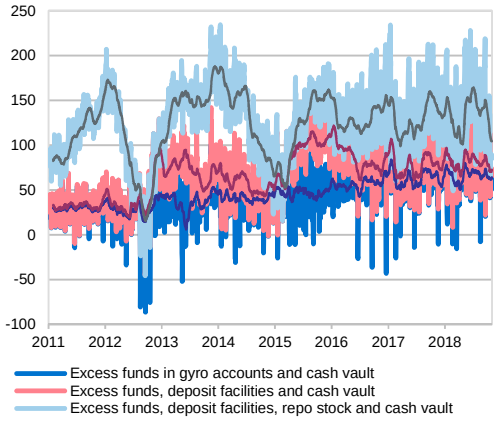
1 Financial market trends

In Q3, interest rates in the interbank money market displayed minimum volatility, while the government's diminished need for financing led to a further drop in interest rates on government securities. The price of new corporate and household dinar loans stayed close to the minimum recorded in the previous months.

Interest rates

In Q3, interest rates in the **interbank money market** displayed minimum volatility. At end-Q3, the average repo rate[4] stood at 2.35%, almost unchanged relative to end-June. BELIBOR rates of all maturities stayed flat from June, moving at end-Q3 from 2.3% for the shortest to 3.1% for six-month maturity. It was only the BEONIA rate that declined in Q3, by 0.2 pp to 2.0% at end-September. As the average daily trading volumes mirrored the Q2-levels (RSD 2.4 bn), a reduction in BEONIA can be attributed to the banks' diminished need to borrow.

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

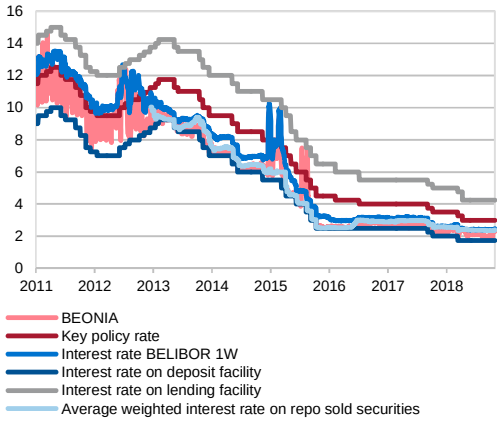


Source: NBS.

In October, average BELIBOR rates of all maturities stayed almost unchanged relative to September. Only BEONIA increased somewhat by the end of the month, up by 0.1 pp on average from September – to 2.1%.

Better than planned fiscal results shaped the trends in the market of **government dinar securities**. Due to its diminished need for finance, the government reduced its auction volumes in Q3, encouraging the continuation of the downward trend of interest rates. In the primary market of dinar securities, five-year rates fell by 0.2 pp to 3.7% in September, while the rates on ten-year securities fell by 0.1 pp to 4.8% in August, when the last auction was held for this maturity.

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

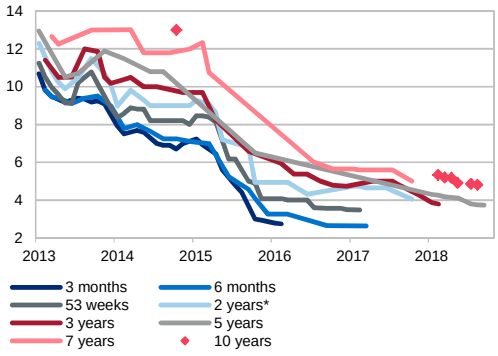


Sources: Thomson Reuters and NBS.

Q3 saw five actions where five- and ten-year dinar benchmark securities were sold worth RSD 27.4 bn

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

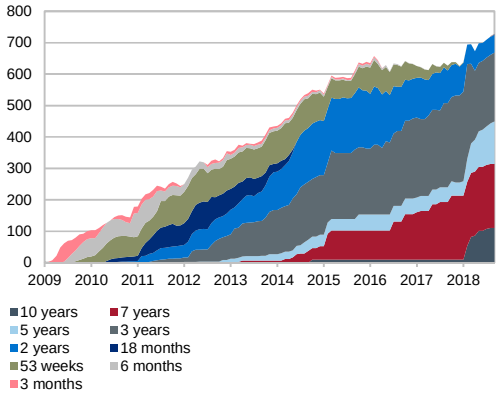
Chart IV.1.3 **Interest rates in the primary market of government securities**
(p.a., in %)



Source: Ministry of Finance.

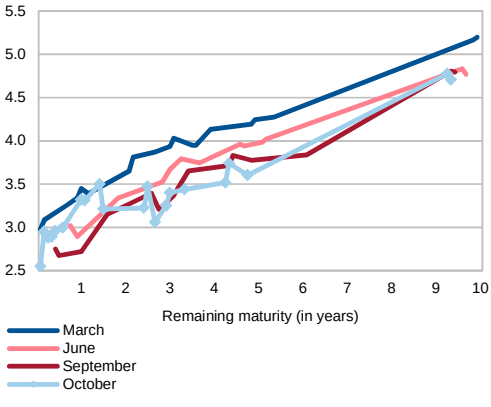
* Excluding coupon securities with the rate linked to the NBS key policy rate.

Chart IV.1.4 **Stock of sold dinar government securities**
(in RSD bn)



Source: Ministry of Finance.

Chart IV.1.5 **Yield curve in the secondary government securities market in 2018**
(average values, p.a., in %)



Source: Central Securities Depository and Clearing House.

nominally. As dinar securities worth RSD 0.4 bn nominally fell due in the same period, the stock of sold dinar securities rose to RSD 726.2 bn in Q3.

Non-residents bought only ten-year benchmark bonds in the primary market, owning around 78% of total sold ten-year bonds issued in 2018. In the secondary market, non-residents were active somewhat more on the sale than the purchase side. As a result, in late September the stock of sold dinar securities owned by non-residents remained almost the same as at end-June. The share of dinar securities owned by non-residents equalled 30.4% in September.

A smaller securities offer by the government in the primary market reflected on lower **trading volumes in the secondary market** – RSD 49.5 bn in Q3. The yield rates on dinar securities dropped further – at end-September, they ranged from 2.7% for six-month and one-year maturity to 4.8% for ten-year maturity.

In October, investor activity in the secondary market increased, resulting in a small rise in interest rates for the remaining maturity of up to two years, while yield rates for longer maturities remained broadly unchanged.

In Q3, the government did not organise any auction of **euro securities**. As the same period saw the maturing of euro securities worth EUR 128.5 mn nominally, the stock of sold euro securities fell to EUR 3,059 mn in Q3.

Owing to solid fiscal results in the year so far, in Q4 the government will not sell securities in the primary market. In November, it plans the first auction for the early repurchase of securities maturing in February 2019. The same type of auctions is planned for December, with purchase amounts set at RSD 10 bn per auction.

Broadly unchanged from June, **interest rates on new dinar corporate and household loans** stood at 5.05% and 10.2% respectively, in September, which is close to the minimum recorded in prior months.

In terms of the structure of new dinar corporate loans, the rate on investment loans fell by 0.6 pp from June, to 5.3%. Interest rates on other non-categorised loans were revised up – by 0.2 pp to 5.3%, while the rates on current assets loans stayed unchanged from June, equalling 4.9% in September.

In regard to dinar household loans, the average rate on cash loans, with the greatest share in new dinar household loans, went up by 0.2 pp to 10.6%, while the rates on

consumer and other non-categorised loans fell by 0.2 pp and 0.4 pp to 8.2% and 8.5% respectively.

The rates on **euro-indexed and euro corporate and household loans** showed minimum changes in Q3. The average rate on euro corporate loans declined marginally – by 0.1 pp to 2.7%, reflecting a reduction in rates on import and investment loans by 0.4 pp and 0.1 pp to 1.7% and 3% respectively. Conversely, the rate on euro household loans increased a tad – by 0.2 pp to 4% in September, in response to higher rates on other non-categorised loans and consumer loans in euros, while the rates on housing loans remained flat at 2.8%.

The decline in savings rates was halted – in Q3 they either stayed unchanged or increased mildly. The rates on FX household savings rose by 0.2 pp to 0.8%, while the rates on euro term deposits of corporates were up by 0.1 pp to 0.8%. The rates on dinar corporate deposits rose by 0.2 pp to 2.7%, while those on household dinar term deposits remained unchanged from June – at 2.6% in September.

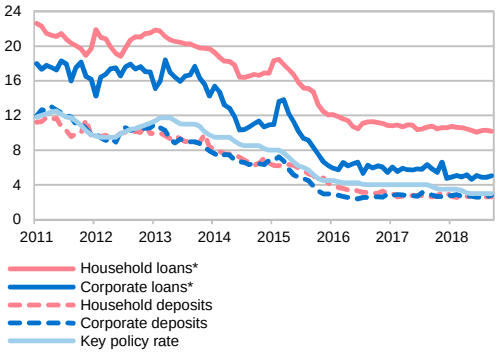
Risk premium

Emerging market risk premium, measured by EMBI Global Composite spread, increased by 27 bp on average in Q3, and EMBI Europe spread was up by 38 bp.

Global factors, such as rising protectionism in international trade, geopolitical tensions and instability in international financial markets pushed up the risk premia of emerging economies, as a group. Worsened macroeconomic indicators in some Latin American countries and Turkey triggered capital outflows from these countries and a sharp rise in their risk premia.

Unlike EMBI Global and EMBI Europe, Serbia's risk premium was on average lower in Q3 than in Q2. It was among the lowest in the region owing to favourable domestic macroeconomic indicators and outlook going forward. It averaged 123 bp in Q3, similarly to the risk premia of Hungary and Croatia. Since the start of the year until end-Q3, average EMBI for Serbia was down by around 50 bp y-o-y. This also confirms that the country risk premium, though somewhat above the record low values observed in January, remains relatively low. The domestic factors conducive to lowering of the country risk premium include significant narrowing in internal and external imbalances, which diminished the need to borrow, and a favourable growth outlook, which helped increase Serbia's resilience to potential shocks from the international environment.

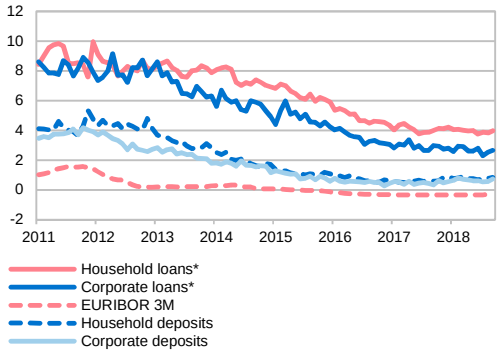
Chart IV.1.6 **Interest rates on new dinar loans and deposits**
(weighted average values, p.a., in %)



Source: NBS.

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

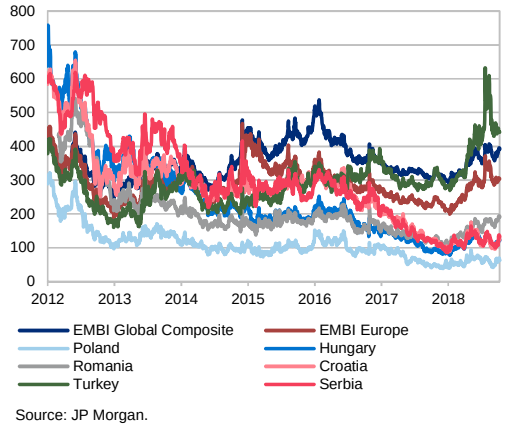
Chart IV.1.7 **Interest rates on new euro and euro-indexed loans and deposits**
(weighted average values, p.a., in %)



Sources: European Banking Federation and NBS.

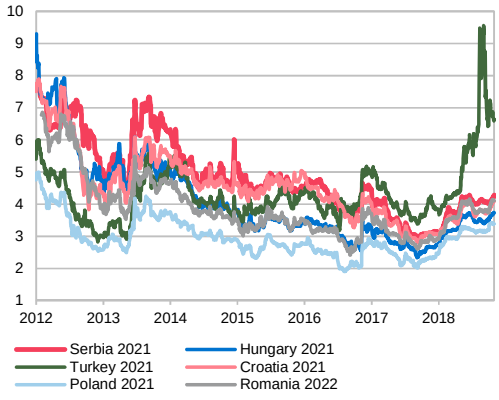
* Excluding revolving loans, current account overdrafts and credit card debt.

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



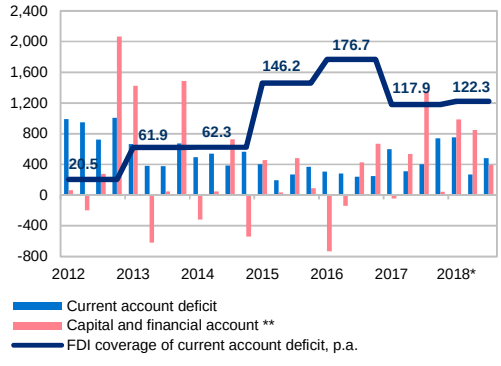
Source: JP Morgan.

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



Source: Bloomberg.

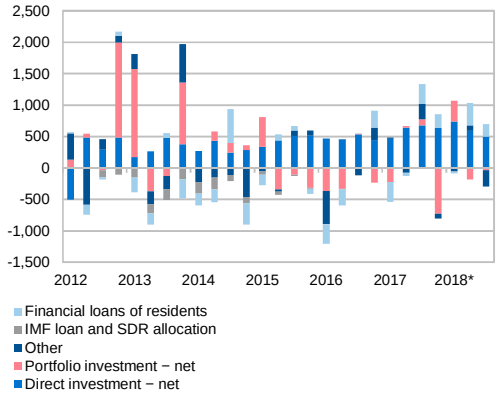
Chart IV.1.10 **Current account deficit and net capital inflow**
(in EUR mn, in %)



Source: NBS.

* Preliminary data for Q3 2018.
** Excl. changes in NBS FX reserves.

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



Source: NBS.

* Preliminary data for Q3 2018.

Responding to rising yields on US ten-year treasuries, in October the risk premia of countries in the region were on average lower than in Q3. Measured by EMBI, Serbia's risk premium stood at 114 bp on average.

Foreign capital inflow

In Q3, the FDI inflow continued to fully cover the current account deficit. Another source of inflow was the credit borrowing of residents, mainly banks, while an insignificant outflow was recorded on account of portfolio investment.

According to preliminary data, the net **FDI** inflow amounted to EUR 503.2 mn in Q3. Thus, from the start of the year the net FDI inflow exceeded EUR 1.8 bn, up by 3.2% y-o-y. This year as well, investment was highly diversified by project and geographically dispersed, with the bulk of it going to export-oriented sectors. In terms of activity, in H1 investment in manufacturing was dominant (32.0%), followed by the financial sector (27.6%), trade (16.9%) and construction and real estate (15.9%). The major part of inflows came from EU countries (around 74%), while investment from Asian countries accounted for around 11% of FDI.

A EUR 32.4 mn net outflow was recorded from **portfolio investment** in Q3, as non-residents in the secondary market of government securities were more active on the sale side, while buying dinar securities in the primary market only in July. Such trends can be associated with continued normalisation of Fed's monetary policy and the expected completion of the ECB's quantitative easing programme on the one hand, and improved fiscal position of the country and the government's diminished need for financing on the other.

In regard to **financial loans**, Q3 saw a net inflow of EUR 192.0 mn, primarily on account of rising net borrowing of banks (EUR 286.2 mn) concerning mainly short-term loans, and, to a lesser extent, higher corporate borrowing (EUR 55.9 mn). On the other hand, the government and the NBS reduced their liabilities to foreign creditors by EUR 146.0 mn and EUR 4.1 mn respectively.

Trends in the FX market and exchange rate

Despite the dinar's nominal weakening against the euro by 0.3%, end-of-period, Q3 was marked by appreciation pressures, which prevailed as of February this year, as well as in the major part of 2017. As the euro-dollar pair remained broadly unchanged in Q3 end-of-period, in Q3 the dinar lost 0.3% against the dollar too.

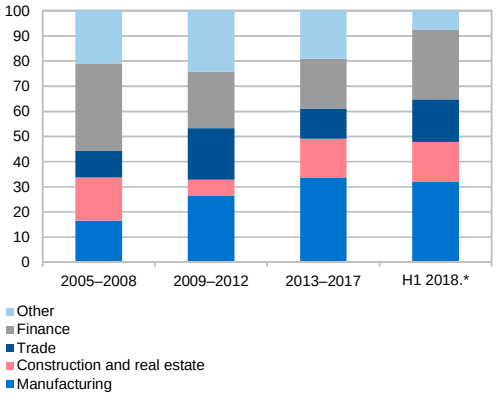
Appreciation pressures were observed particularly in July and August, reflecting the continued dynamic export growth and a high FDI inflow. The pressures abated in September, with milder depreciation pressures noted in some days of the month. In terms of factors of the domestic FX market, appreciation pressures were fuelled by elevated net FX cash purchases, increased non-resident card payments, customary for summer months owing to tourism FX inflows, and rising FX-indexed corporate borrowing. These inflows significantly exceeded the FX demand of domestic enterprises and non-residents in July and August, while in September FX demand and supply were almost balanced.

To ease excessive short-term volatility of the dinar against the euro, in Q3 the NBS intervened in the IFEM purchasing EUR 405.0 mn net. In July and August, it intervened on the purchase side only, with EUR 410.0 mn. In September, it intervened once on the purchase and once on the sale side. The sale intervention worth EUR 15.0 mn was the first such intervention since January 2018.

In October, FX demand and supply remained broadly balanced, with softer depreciation pressures observed on some days. End-of-period, the dinar gained 0.1% in October, with the NBS intervening twice on the sale side with EUR 30.0 mn in total.

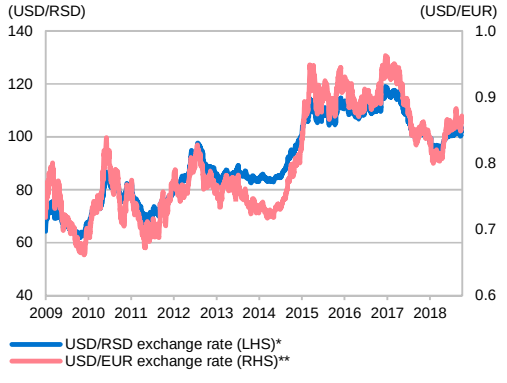
Average daily trading volumes[5] stood at EUR 22.1 mn in Q3, down by EUR 1.5 mn from Q2. In July and August, they equalled EUR 21.0 mn and increased to EUR 24.4 mn in September. Consistent with rising trading volumes in September and measured by EWMA[6] и EGARCH[7], the dinar was somewhat more volatile against the euro.

Chart IV.1.12 **FDI structure by sector**
(in %)



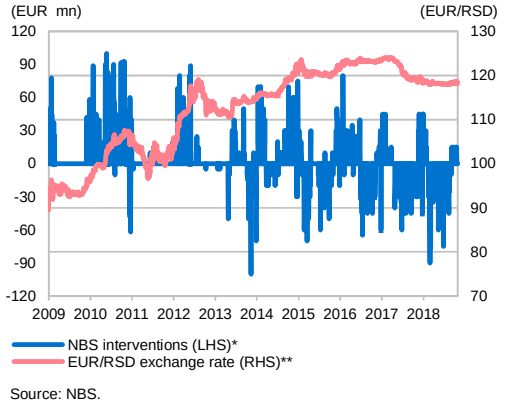
Source: NBS.
* Preliminary data.

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



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

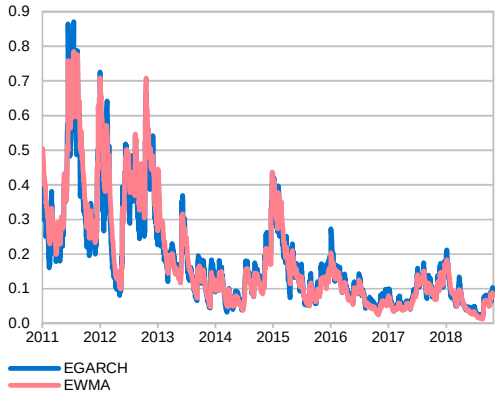
Chart IV.1.14 **Movements in EUR/RSD exchange rate and NBS FX interventions**



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

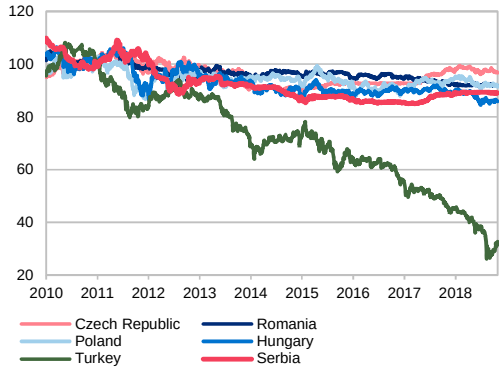
[5] Excluding the NBS.
[6] EWMA – Exponentially Weighted Moving Average.
[7] EGARCH – Exponential General Autoregressive Conditional Heteroskedasticity.

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



Source: NBS.

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



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

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

	2017	2018			Share in M3 Sept. 2018 (in %)
	Dec.	March	June	Sept.	
M3	3.6	3.3	7.9	8.2	100.0
FX deposits	1.1	0.5	4.6	5.2	61.6
M2	7.9	8.5	13.7	13.5	38.4
Time and savings dinar deposits	0.9	6.0	14.4	8.7	9.4
M1	10.2	9.4	13.5	15.1	29.1
Demand deposits	12.7	11.3	14.9	14.6	21.9
Currency in circulation	2.9	3.8	9.5	16.5	7.2

Source: NBS.

In Q3, at two-week and three-month swap auctions the NBS bought and sold EUR 27.0 mn each, down by EUR 1.0 mn than in Q2 in case of three-month, and up by EUR 24.0 mn in case of two-week swaps.

Other currencies of countries in the region running similar exchange rate regimes displayed divergent movements in Q3. The Polish zloty appreciated (2.1%), followed by the Hungarian forint (1.5%) and Czech koruna (1.2%). The Romanian leu weakened somewhat (0.1%), while the Turkish lira lost 25.1%.

2 Money and loans

Growth in economic and lending activity lent further impetus to monetary aggregates in Q3. Despite the continued NPL resolution efforts, y-o-y growth in domestic loans accelerated to 7.7% in September.

Monetary aggregates

Owing to economic and lending growth, y-o-y growth in monetary aggregates M1, M2 and M3 accelerated relative to end-2017, equalling 15.1%, 13.5% and 8.2% in September, respectively. Acting in the opposite direction were rising government deposits with the NBS, owing to the surplus achieved and successful five- and ten-year securities auctions.

Since the start of the year, an impetus to total money growth came both from the dinar and FX component. Owing to achieved macroeconomic stability, notably low and stable inflation and relative stability of the exchange rate, the share of dinar corporate and household deposits in total deposits increased to 31.0%, up by 0.2 pp from end-2017.

Since early 2018, demand deposits expanded by RSD 16.8 bn, mirroring rising transaction deposits of households (RSD 23.1 bn). Economic acceleration brought about an upward trend of transaction deposits of companies for a year already, and a rise of RSD 6.5 bn in nine months. On the other hand, owing primarily to the payment of profit to the government budget by some public enterprises, transaction deposits of these enterprises fell by RSD 15.0 bn.

Term dinar deposits went up by RSD 21.2 bn since the start of the year, thanks primarily to rising deposits of

corporates (RSD 9.7 bn), notably in the trade sector. Dinar household savings[8] were on a constant rise as well (RSD 6.4 bn), reaching their new high in September – RSD 55.9 bn.

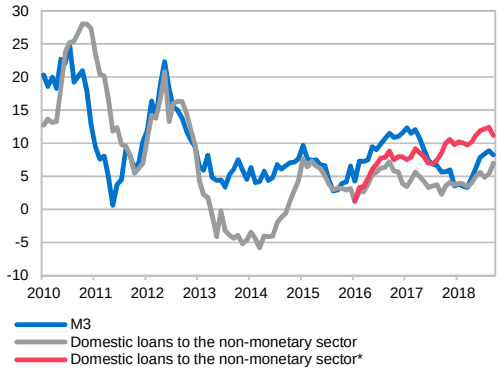
Growth in FX deposits in the first nine months of 2018 (EUR 559.3 mn) was led primarily by rising FX household savings (EUR 396.4 mn), which reached their highest in September – EUR 9.5 bn. Owing to FX inflows from exports, FDI and corporate borrowing abroad, since the start of the year FX corporate deposits increased by EUR 114.1 mn. Working in the opposite direction were elevated payments based on imports of equipment and raw materials for the needs of the current investment cycle.

Loans

Excluding the exchange rate effect[9], y-o-y growth in domestic loans was faster than at end-2017, reaching 7.7% in September. In terms of structure, household and corporate loans were up by 12.3% and 4.1% y-o-y respectively. The growth was recorded against the background of continued NPL resolution efforts which, since the start of the year, resulted in the NPL write-off of RSD 26.5 bn and sale of RSD 26.4 bn to non-banking sector entities directly from bank balance sheets. Excluding the effect of NPL write-off and sale[10], y-o-y growth in domestic loans equalled 11.9% in September, of which 13.9% in the household and 10.7% in the corporate segment.

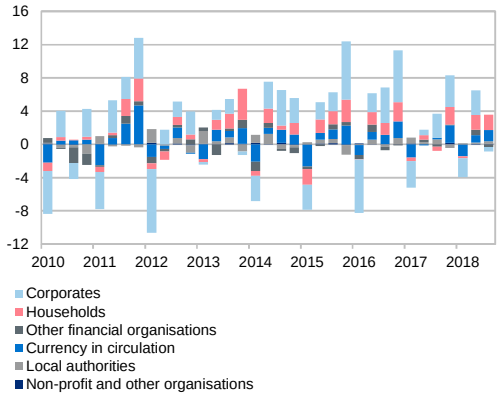
Excluding the exchange rate effect, **corporate loans** increased by RSD 10.8 bn **in Q3**. The total increase is due to elevated lending to companies, while loans to public enterprises stayed broadly unchanged from end-Q2. **In terms of activity**, growth in corporate loans was led primarily by a rise in lending to trade, agriculture and construction enterprises, and to a lesser extent enterprises in the field of real estate and energy. NPL sales and a considerable loan amount falling due in August led to a lower stock of loans in manufacturing and transportation than at end-Q2. **By purpose**, loans for current assets financing continued to make up the bulk of corporate loans (49.0%), followed by investment loans (31.4%).

Chart IV.2.1 **Domestic loans to the non-monetary sector and M3**
(nominal y-o-y rates, in %)



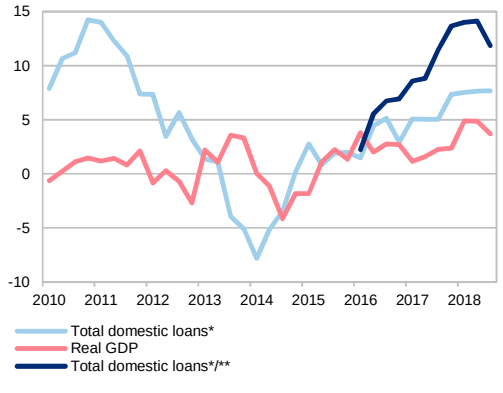
Source: NBS.
* Excluding the effect of NPL write-off and sale since early 2016.

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



Source: NBS.

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



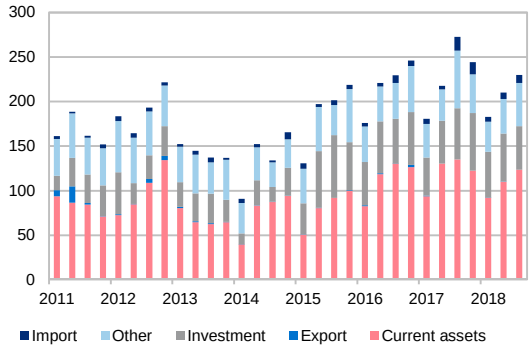
Sources: NBS and SORS.
* Excluding the exchange rate effect.
** Excluding the effect of NPL write-off and sale since early 2016.

[8] Including only resident assets.

[9] Calculated at the exchange rate of the dinar against the euro, Swiss franc and dollar as at 30 September 2014 (the so-called programme exchange rate used for the purposes of IMF arrangements), taking into account the currency structure of loan receivables.

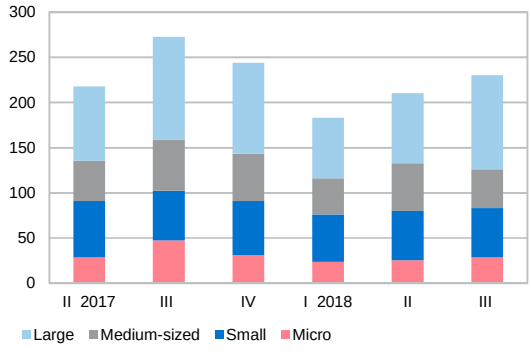
[10] Excluding the effect of NPL write-off and sale since the start of 2016. As at September 2018, banks wrote off NPLs worth RSD 172.8 bn (of which RSD 130.8 bn in the corporate and RSD 37.2 bn in the household sector) and sold RSD 80.4 bn of NPLs, which were at that moment in their balance sheets.

Chart IV.2.4 **Structure of new corporate loans, by purpose**
(in RSD bn)



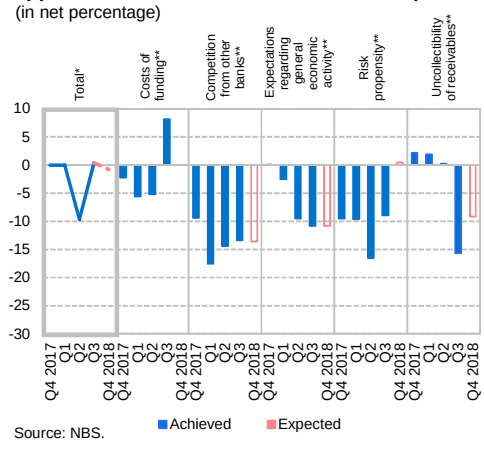
Source: NBS.

Chart IV.2.5 **Structure of new corporate loans, by enterprise size**
(in RSD bn)



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.

In Q3, the volume of **new corporate loans** (RSD 229.9 bn) was higher by 9.4% than in Q2. As in the prior period, in Q3 the bulk of new loans were current assets loans (53.8%) and investment loans (21.1%). Since the start of the year, investment loans worth RSD 153.6 bn were approved, up by 3.4% from the same period of 2017. This suggests that loans, almost to the same extent as FDI, were the source of investment funding this year just as in the last three years. **In terms of enterprise size**, close to 60% of total new current assets loans and almost 75% of new investment loans in Q3 concerned the segment of microenterprises and SMEs, which suggests higher availability of funding for this group of enterprises.[11]

According to the **October NBS bank lending survey**[12], banks believe that credit standards remained unchanged in the **corporate sector** in Q3, which is consistent with the expectations reported in the previous survey. However, in Q3 as well, the majority of factors worked toward standards easing, with NPLs, banking sector competition and a positive economic outlook being recognised as the key drivers. According to banks, this will lead to the easing of credit standards in Q4 as well. According to the survey results, in Q3 banks eased price conditions of corporate loans, increased maximum maturity and the amount of loans, and in the case of FX loans reduced collateral requirements. Banks assessed that corporate loan demand increased in Q3, reflecting the need to finance current assets and capital investment. The same needs are expected to remain the main drivers of corporate loan demand in Q4 as well.

Excluding the exchange rate effect, **household loans** picked up by RSD 32.6 bn in Q3. The bulk of loans concerned cash loans (including refinancing loans) and housing loans, which picked up by RSD 19.2 bn and RSD 8.3 bn in Q3 respectively. Since the start of the year, housing loans went up by RSD 20.7 bn, exceeding the growth recorded in the entire previous year, which contributes to the recovery of the real estate market. Economic growth was boosted by higher lending to entrepreneurs, whose investment loans were up by RSD 2.4 bn in Q3.

In Q3, the **volume of household loans** (RSD 118.3 bn) was down by 7.5% q-o-q and up by 8.0% y-o-y. Households continued to use predominantly cash and refinancing loans, which made up around 60% of new

[11] See Text box 1, p. 26.

[12] The NBS implements the survey since the start of 2014.

household loans, with over 99.0% of those loans dinar-denominated (almost three fourths with the repayment term of over five years). The volume of new housing loans (RSD 19.5 bn) was up by 1.9% from Q2.

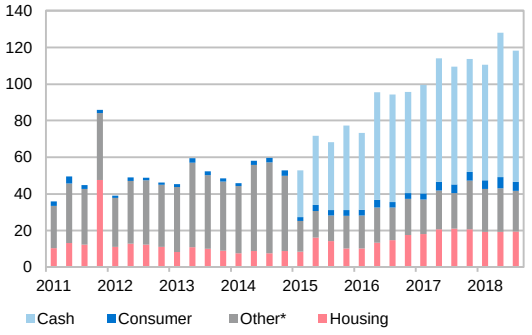
According to the results of the **October bank lending survey, household credit standards** were eased in Q3, notably for dinar cash loans and refinancing loans, as well as for FX housing loans. Interbank competition, greater risk propensity and lower funding costs reflected on the easing of credit standards. As assessed by banks, household borrowing terms were more favourable in respect of lower interest margins and other accompanying costs for all loans, while in the case of dinar loans, the requirements in terms of collateral and extension of repayment deadlines were reduced. Banks expect further easing of credit standards in Q4, under the impact of banking sector competition and lower funding costs. In addition, household loan terms will be more favourable both in terms of price and collateral requirements. Q3 saw a rise in household demand for dinar cash and consumer loans and FX housing loans. Demand was led by the need to refinance and purchase real estate, which was further supported by the positive situation in the real estate market. According to survey results, the same factors, along with the need to purchase durable consumer goods, are expected to continue to impact growth in loan demand in Q4 as well.

The share of dinar receivables in total **corporate and household receivables was** 32.8% at end-September (up by 0.5 pp relative to June). The dinarisation of household receivables rose to its highest level of 53.2% in September, and that of corporate receivables stayed unchanged from end-Q2 – at 14.6%.

The NPL Resolution Strategy has produced excellent results. For somewhat more than three years since its adoption, the NPL amount fell by over 67% and the NPL share in total loans was reduced by 16.0 pp. **Such results, along with preserved financial stability owing to NBS macroprudential policy, contributed to Serbia's progress on the World Economic Forum's competitiveness list for 2018 in the context of financial soundness indicators.** Since the start of the year, the NPL share in total loans fell by 3.4 pp to 6.4% in September, of which the NPL share in the corporate sector fell by 4.7 pp to 5.7%[13], and in the household

[13] Including companies and public enterprises. Taking into account companies only, in September the NPL share in total loans was 5.8%, down by 5.1 pp from December 2017.

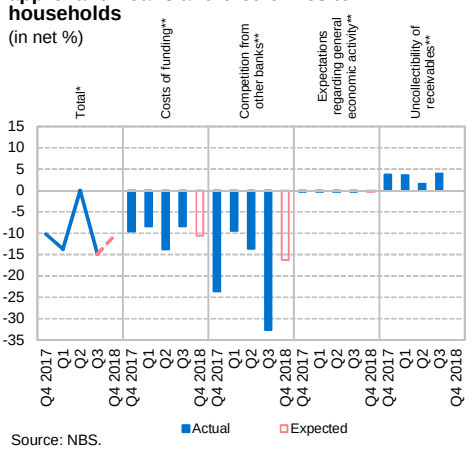
Chart IV.2.7 **Structure of new household loans**
(in RSD bn)



Source: NBS.

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

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 %)

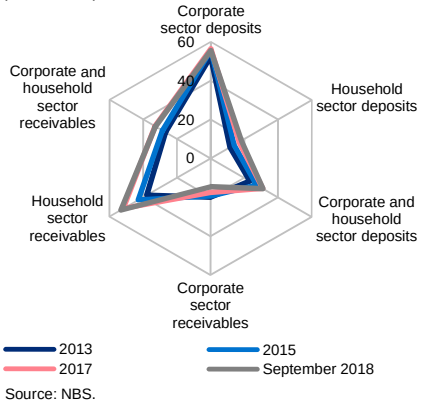


Source: NBS.

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

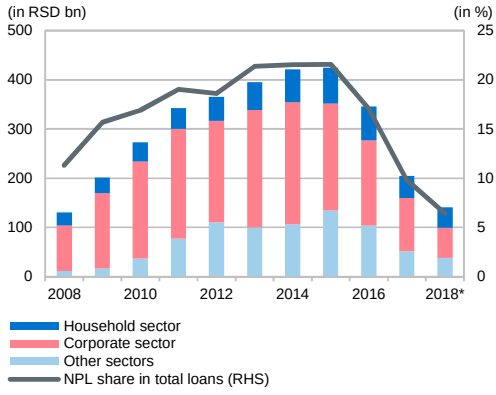
** Positive values indicate the contribution of individual factors to tightening, and negative values indicate the contribution to easing of credit standards.

Chart IV.2.9 **Dinarisation of corporate and household deposits and receivables**
(stock, in %)



Source: NBS.

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

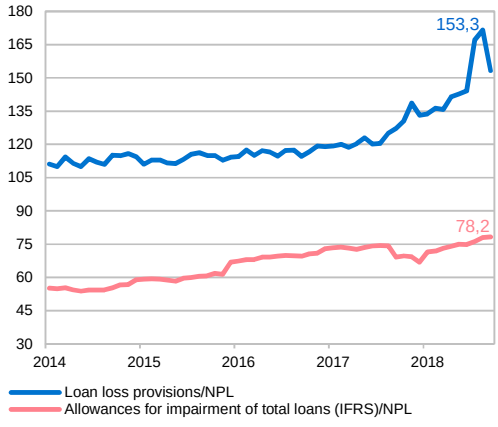


Source: NBS.

* September 2018.

sector by 0.9 pp to 4.7%.[14] The NPL coverage remains high. Impairment allowances of total loans stood at 78.2% of NPLs in September, with loan loss provisions still fully covering gross NPLs (153.3% in September). After the introduction of Basel III[15], the capital adequacy ratio increased further, to 22.8% in Q3, signalling high capitalisation of the domestic banking sector.

Chart IV.2.11 **Selected banking sector indicators**
(in %)



Source: NBS.

[14] Including entrepreneurs and private households, the share fell by 1.0 pp to 4.9%.

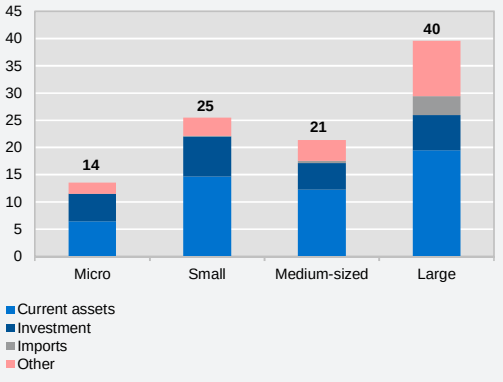
[15] The regulatory Basel III framework is applied as of 30 June 2017.

Text box 1: Lending to small and medium-sized enterprises through the lenses of the new interest rate statistics

In almost all countries, small and medium-sized enterprises are the most vital part of the economy and a major contributor to employment and GDP growth. They are also recognized as the drivers of economic growth in Serbia too, since they are flexible and innovative and thus more easily adaptable to changes in the domestic and global market. Growth and development of these enterprises largely depend on the ability to find more favourable sources of funding, so their access to bank financing is carefully monitored and analysed in the NBS. The data needed for these analyses are obtained from different sources – official statistics, surveys and direct contacts with banks and other relevant institutions. In that context, the new NBS statistics published since September brings value added, as it broadens the interest rate statistics for new loans and deposits by collecting data by the criterion of enterprise size and the type of interest rate indexation for dinar loans. The broadening of the existing statistics facilitates the monitoring and assessment of the monetary policy transmission mechanism and, primarily, of the accessibility of sources of funding and terms of private sector borrowing from banks and contribution to economic growth on that account.

The published data series on enterprise size, covering the period from March 2017 until September 2018 shows that in the structure of new corporate loans, micro, small and medium-sized enterprises on average account for around 60% and large enterprises for 40%. A relatively robust share of the large enterprise category reflects high loan amounts approved to those enterprises, corresponding to higher financial needs. On the other hand, the micro-enterprise segment[1], registering the greatest number of entities, refers to around 14% of new corporate loans. This is due to the fact that these enterprises are mostly perceived as higher-risk clients, as they frequently include startups, with no credit history and no adequate collateral to offer, or innovative enterprises bearing a higher business risk. On the other hand, in case of small and medium-sized enterprises, which account for 25% and 21% of new corporate lending, respectively, the majority of obstacles found in micro segment lending were removed. These enterprises have well-developed relations with banks, credit history, sufficient funds to use as a collateral, elaborate business plans and established position in the market.

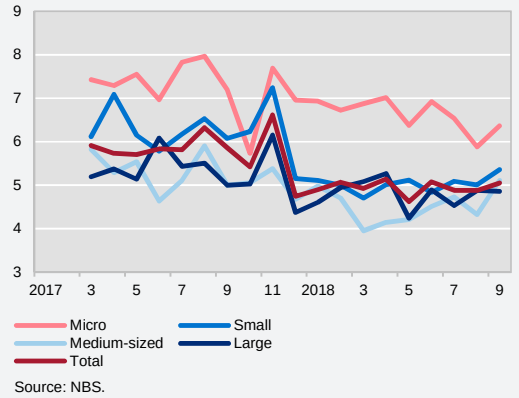
Chart O.1.1 **Structure of new loans by enterprise size and purpose in the period March 2017 – September 2018**
(in %)



Source: NBS.

In terms of enterprise size, almost two-thirds (63%) of total new current assets loans and close to three-fourths (73%) of new investment loans in the period observed referred to the segment of micro, small and medium-sized enterprises. As for the structure of lending in the corporate segment, current assets loans make up the greatest share of new loans of small and medium-sized enterprises (around 57%), while accounting for a bit lesser share in new loans of large and micro enterprises (49% and 47%, respectively). Investment loans are most prevalent in lending to micro and small enterprises, making up 37% and 29% of new loans. The amount of new investment loans approved to micro enterprises in the period March 2017 – September 2018 (RSD 71.8 bn) is higher than the amount approved to medium-sized enterprises (RSD 69.5 bn). Import loans, whose disbursement

Chart O.1.2 **Interest rates on dinar corporate loans, by enterprise size**
(weighted average values, p.a., in %)



Source: NBS.

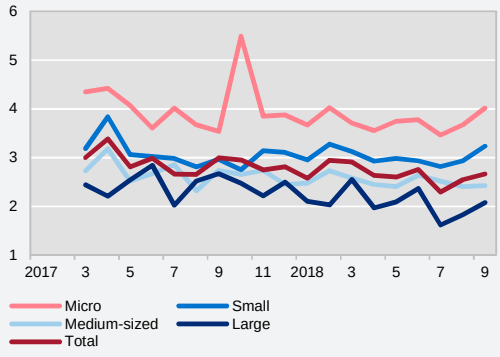
[1] Entrepreneurs and agricultural producers, which are frequently observed together with the micro segment, are not covered by this statistics. This is because ECB standards, with which the statistics is harmonised, put them in the household sector.

increased since last year, are used primarily by large enterprises, though these loans account for only 9% of their credit borrowing.

Around 18% of new corporate loans are in dinars, and the degree of dinarisation is the highest in the large enterprise segment (around 22%), since they, together with medium-sized enterprises, are offered the most favourable interest rates on dinar loans – in September 2018, medium-sized enterprises borrowed at a rate of 5.1%, and large enterprises at a rate of 4.9%. Since the beginning of 2018, the price of dinar borrowing of small enterprises has moved around the average for the corporate sector, though in some months it fell below the interest rate on loans to large enterprises. Interest rates for the segment of micro enterprises are still above the average, though posting the sharpest fall in the period observed (by 1.1 pp to 6.4% in September), while the average interest rate on dinar loans to corporates dropped by 0.9 pp to 5.05%.

Micro enterprises borrow at a somewhat higher rate also when taking euro loans – 4.0% in September, which is 1.1 pp above the average interest rate for the corporate sector[2]. Interest rates on euro loans approved to small enterprises (3.2% in September) are close to the average, but mostly above it, while rates for medium-sized enterprises (2.4% in September) are slightly below the average. Large enterprises enjoy the most favourable borrowing terms, as they recorded the lowest price of borrowing almost throughout the period (2.1% in September).

Chart O.1.3 **Interest rates on FX corporate loans, by enterprise size***
(weighted average values, p.a., in %)



Source: NBS.
* Euro and euro-indexed.

The results of lending surveys point to similar conclusions regarding the dynamic of credit activity and terms of borrowing of small and medium-sized enterprises – i.e. this corporate segment contributes the most to loan demand and enjoyed the greatest easing in credit standards. At the same time, survey results show that the quality of credit applications in the segment of small and medium-sized enterprises improved significantly and that a further improvement is expected in the future period. More favourable terms of financing of small and medium-sized enterprises were confirmed in the international competitiveness list of the World Economic Forum 2018, where the progress is recorded also among the indicators pertaining to the financial system, specifically, the indicator on financing of small and medium-sized enterprises. All this taken together gives rise to the expectation that this corporate segment will continue to develop, providing impetus to economic growth and labour market recovery. On its part, the NBS will continue to strengthen its statistical reporting, for the sake of easier monitoring and assessment of credit terms, transparent informing of the public and strengthening competition among banks.

[2] Euro-indexed and euro loans make up 99% of new FX-indexed and FX corporate loans, while the remaining 1% are loans that are denominated in or indexed to the US dollar. The statistics is available for total FX and FX-indexed loans.

3 Real estate market

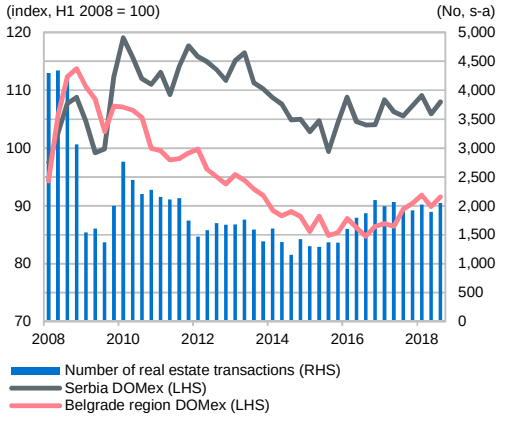
In Q3, prices and turnover in the real estate market went up. Judging by supply and demand indicators, a further recovery in this market may be expected going forward.

As measured by DOMex[16], the average price of real estate in Serbia increased by 2.0% in Q3, with prices rising in all regions. Apart from rising q-o-q, the average price of real estate in Serbia increased also in y-o-y terms (2.3%). The rise in prices was triggered by higher demand, signalled by the 8.2% s-a hike in turnover in Q3. Real estate turnover was the highest in the last five quarters and distributed in all regions save southern and eastern Serbia.

The average price of real estate in Serbia in Q3 equalled EUR 895.5 per square metre, and the highest price, as usual, was recorded in the Belgrade region (EUR 1,193.1 per square metre). The ratio of the prices in the Belgrade region and other regions remained unchanged from the last quarter, at 1.83.

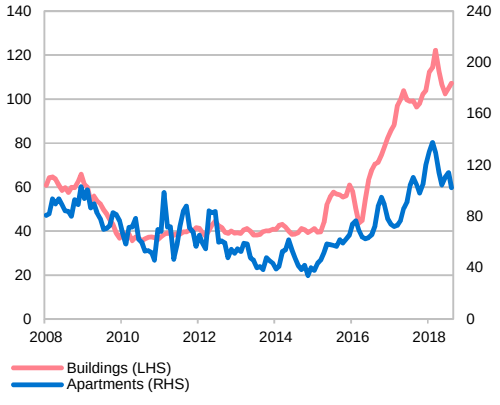
Favourable trends in the real estate market are likely to continue in the period ahead, on account of an increase in both demand and supply. The factors which are likely to spur real estate demand are further growth in wages and employment in the private sector and more favourable terms of housing lending which, according to the lending survey, should persist in the coming period. Higher supply in the real estate market is indicated also by the continued rise in the number of construction permits for apartment housing in July and August (8.3% y-o-y) and the projected value of the works to be performed on those grounds (20.9% y-o-y).

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



Source: National Mortgage Insurance Corporation.

Chart IV.3.2 **Indices of the number of issued construction permits**
(quarterly averages s-a, 2017 = 100)

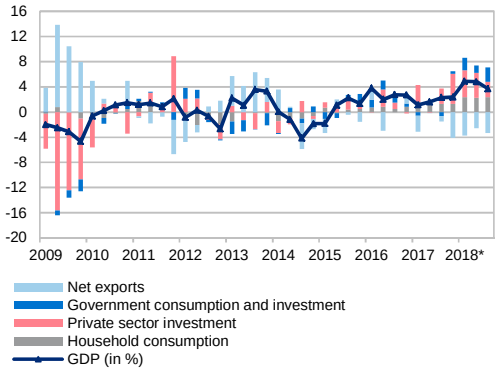


Sources: SORS and NBS calculation.

4 Aggregate demand

Further strong growth in fixed investment, supported by intensive implementation of infrastructure projects and favourable financial conditions, was the major factor in maintaining the robust pace of GDP growth in Q3 (3.7% y-o-y according to the preliminary estimate of the Statistical Office). A continued strong impetus to GDP growth came also from household consumption, which rose on the back of financial conditions and favourable trends in the labour market, as well as higher consumer confidence, amid

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



Sources: SORS and NBS calculation.

* NBS estimate for Q3 2018.

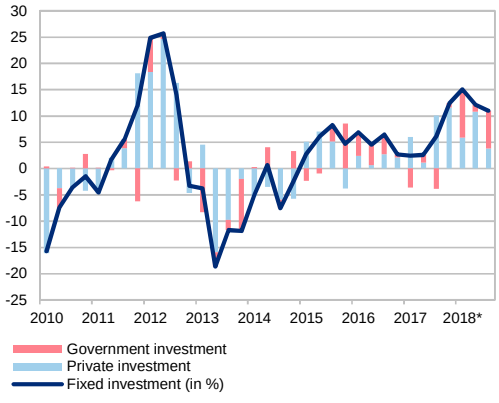
[16] The DOMex is published by the National Mortgage Insurance Corporation and relates only to real estate purchased by insured loans.

Table IV.4.1 **Movement in main indicators and sources of household consumption**
(real y-o-y growth rates, in %)

	2017	2018		
	Q4	Q1	Q2	Q3
Household consumption	**1.8**	**3.1**	**3.1**	**3,3***
Indicators				
Retail trade	2.2	3.3	3.3	4.8
Catering turnover	-1.5	9.6	10.7	10,6**
Number of domestic tourists	9.8	10.1	8.7	8.6
Number of overnight stays of domestic tourists	11.3	9.2	13.6	10.2
Consumer goods imports (BEC classification), nominal	6.0	13.0	5.7	10.4
Sources				
Total wage bill, nominal	5.9	7.5	8.9	10,3**
Net remittances inflow, nominal	21.5	12.0	15.6	35.5
New consumer and cash loans, nominal	13.6	8.3	17.5	10.8

Sources: SORS and NBS calculation.
* NBS estimate.
** July-August.

Chart IV.4.2 **Fixed investment***
(y-o-y growth, in pp)



Sources: SORS and NBS calculation.
* NBS estimate for Q3 2018.

Table IV.4.2 **Investment indicators**

	2017		2018		
	Q3	Q4	Q1	Q2	Q3
Real y-o-y growth rates (in %)					
Fixed investment (national accounts)*	6.2	12.4	15.1	12.1	11.0
Construction (national accounts)*	6.0	17.9	28.2	22.9	15.0
Government investment*	-22.9	3.4	135.5	7.8	58.2
Number of construction permits issued**	32.2	31.3	46.1	6.9	8.2
Production of construction material	-2.0	10.2	7.9	7.0	11.0
Value of works performed	10.4	23.4	30.0	24.9	7.0
Imports of equipment, nominal	8.1	20.9	29.3	13.2	15.8
Production of domestic machinery and equipment	33.6	16.2	7.8	14.1	3.5
Finished product inventories in industry	9.66	14.3	10.3	9.7	13.7

Sources: SORS and NBS calculation.
* NBS estimate for Q3.
** July-August.

announced increases in pensions and public sector wages and the minimum cost of labour. The net exports contribution to GDP remained negative in Q3, as imports of goods and services grew faster than exports.

Domestic demand

Household consumption continued up in Q3, thanks to positive movements in the labour market, favourable financial conditions and growth in consumer confidence, spurred by announced increases in pensions and public sector wages and the minimum cost of labour. According to our estimate, in Q3 household consumption speeded up to 3.3% y-o-y, adding 2.4 pp to GDP. Such trends are signalled by further real growth in retail trade, which accelerated additionally in Q3 (to 4.8% y-o-y), as well as the available indicators in tourism – a higher number of domestic tourists (8.6% y-o-y) and their overnight stays (10.2% y-o-y) in the same period. Relative to Q2, household consumption increased by 0.7% s-a in Q3, giving a 0.5 pp contribution to GDP growth.

The rise in this component of domestic demand is also signalled by the movement in its main sources in Q3. Total nominal wage bill continued up in Q3, increasing on average by 10.3% y-o-y in July and August, thanks to the uninterrupted rise in private sector employment and higher average wages. The remittances inflow also remained on an upward path, rising by 35.5% y-o-y in Q3. Positive trends were also recorded in new consumer loans.

Apart from household consumption, another positive contributor to GDP in Q3 was **final government consumption** (0.7 pp), which edged up by 4.0% y-o-y. Such trend is indicated by higher wage expenditures in July and August, stemming from the public sector wage increase early in the year, while employment in this sector shrunk further, consistent with the rightsizing. In addition, July and August also saw higher expenditures for the purchase of goods and services compared to the same period the year before. Final government consumption edged up by 0.5% s-a relative to Q2, giving a positive contribution to GDP (0.1 pp).

An improved business environment, favourable financing conditions, as well as continued intensive investment into infrastructure, reflected positively on the rise in fixed investment in Q3 (11.0% y-o-y, contribution of 2.4 pp). Growth in fixed investment was spurred primarily by **government investment**, as a result of accelerated implementation of infrastructure projects, as indicated by the real growth of capital budget expenditures of as much

as 112.0% y-o-y in July and August. Positive trends continued also in **private investment**, as confirmed, among other things, by housing construction, which benefited from the gradual recovery in the real estate market. The production of construction material increased by 11.0% y-o-y and the value of works performed by 7.0% y-o-y. Favourable trends persisted in investment in equipment, whose imports remained on an upward path (15.8% y-o-y) for the fifteenth consecutive quarter, while the domestic production of machinery and equipment also expanded in Q3 (3.5% y-o-y). In quarterly terms, fixed investment enjoyed uninterrupted growth seven quarters in a row and, according to our estimate, edged up by 0.8% s-a from Q2.

Positive trends in investment are signalled also by the movement in their main funding sources. The FDI inflow in Q3 came at EUR 503.2 mn, and, similarly to the previous period, a part of investment was financed by new investment loans.

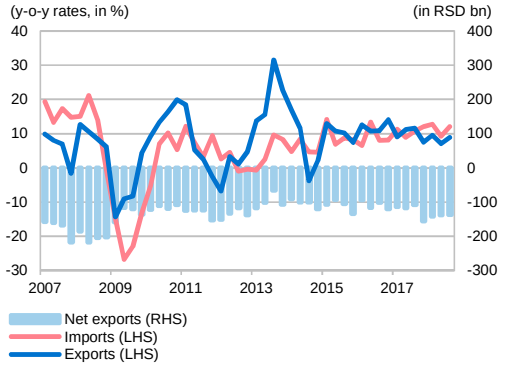
A positive contribution to GDP in Q3 also came from changes in inventories, as indicated by higher finished product inventories in industry (13.7% y-o-y) in the period observed. Inventories also benefited from an extraordinary agricultural season, which led to stronger inventories of agricultural products.

Net external demand

Goods and services exports accelerated in real terms in Q3 (8.9% y-o-y), driven by agricultural exports growth thanks to an excellent agricultural season and the rising exports of manufacturing industry. Still, the real growth of goods and services imports (12.1% y-o-y) outpaced the exports, mostly on account of higher imports of equipment and intermediate goods needed in industry and construction, so the contribution of net exports to GDP remained negative in Q3 as well (3.4 pp).

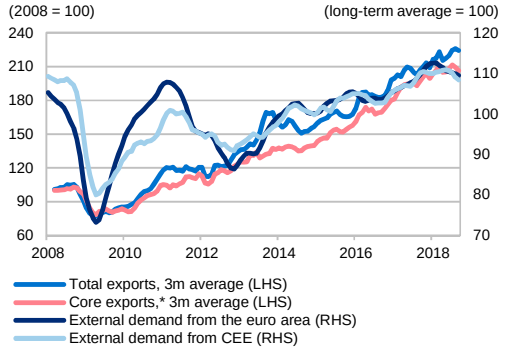
According to external trade data, goods exports in euro terms increased by 8.4% y-o-y in Q3, driven by manufacturing exports that were on the rise for the fifteenth consecutive quarter. In Q3, that growth came at 8.0% y-o-y and remained widely dispersed (19 of 23 sectors). The greatest positive contribution to manufacturing growth came from exports of base metals which increased by 12.9% y-o-y in Q3, as well as from exports of petroleum products. The rise in motor vehicles exports also continued (7.8% y-o-y), and lower exports of the Fiat company (by EUR 30.9 mn or 18.0% y-o-y) were more than compensated by higher exports of other producers in the automobile industry (by EUR 50.4 mn or

Chart IV.4.3 **Exports and imports of goods and services**
(in previous-year constant prices, ref. 2010)



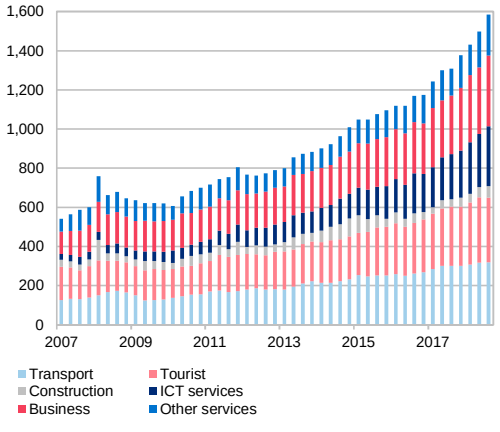
Sources: SORS and NBS calculation.
* NBS estimate for Q3 2018.

Chart IV.4.4 **Movement of indicators of external demand for Serbian exports**
(3m moving avarage, s-a)



Sources: European Commission, SORS and NBS.
* Core exports are total exports excluding exports of agricultural products, base metals, motor vehicles, petroleum products and electricity.

Chart IV.4.5 **Exports of services**
(s-a data, in EUR mn)

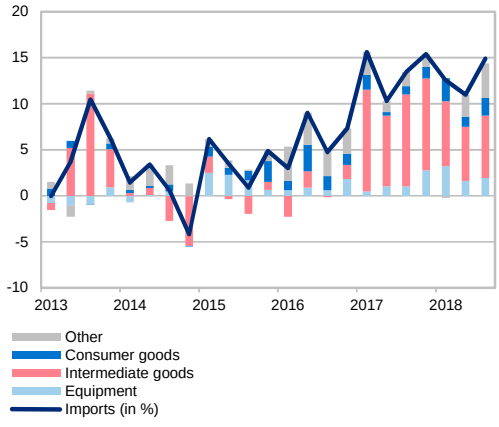


Sources: SORS and NBS calculation.

35.3% y-o-y). As usual, a high contribution came from exports of chemical products, machinery and equipment, rubber and plastic products and metal products. Conversely, Q3 saw a decline in exports of food and pharmaceutical products and, to a lesser extent, tobacco products and electrical equipment.

An extraordinary agricultural season and higher yields of main agricultural crops created a sound export base for H2 2018 and H1 2019. Positive trends were recorded in Q3 when, due to somewhat weaker performance in H1, exports of agricultural products went up by 18.3% y-o-y. The main contributor were wheat exports, which in Q3 climbed to their highest quarterly figure in five years (around 550,000 tonnes).

Chart IV.4.6 **Movement of key import components**
(contributions to y-o-y growth, in pp)

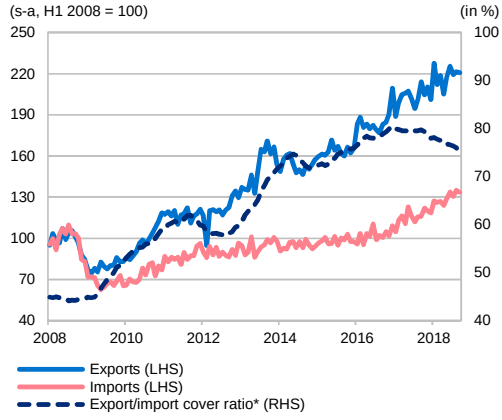


Sources: SORS and NBS calculation.

Favourable trends also continued in services exports which speeded up to 16.3% y-o-y in Q3. The strongest positive impetus to this growth continued to stem from robustly growing exports of information-communication services, at over 30% y-o-y in Q3. If they were to continue at a similar pace, exports of these services will likely surpass EUR 1.0 bn in 2018. In addition, a high contribution also came from exports of business services, and, to a somewhat lesser extent, exports of tourist, transport and construction services.

The continuation of the investment cycle and increased needs in industry and construction for imported raw materials and intermediate goods triggered further growth of goods imports. According to foreign trade data, goods imports in euro terms rose by 16.0% y-o-y in Q3, with imports of equipment rising by 15.8% y-o-y, and of intermediate goods by 11.6% y-o-y. Consistent with the expectations, imports rose on the back of higher imports of consumer goods (10.4% y-o-y), reflecting recovered domestic demand. Similar trends are confirmed by the imports structure according to the EU classification of end-use categories, which shows that greatest contributions came from energy, intermediate and capital goods and lesser from non-durable and durable consumer goods.

Chart IV.4.7 **Trade in goods in euros**



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

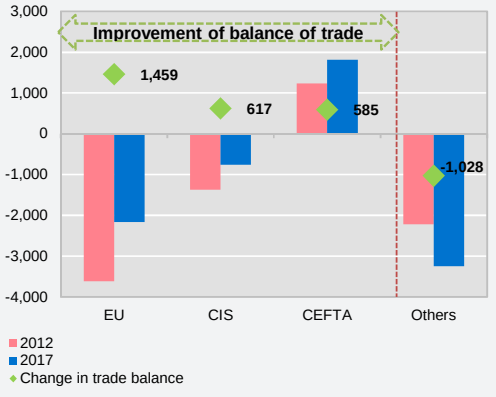
The exports-to-imports ratio, measured by a 12-month moving average, stood at 75.3% in September, or 84.5% if services are included, which is slightly lower than in June. In September, exports of goods were 120.7%[17], and imports of goods 33.5% above their pre-crisis levels.

[17] H1 2008.

Text box 2: Improvement of Serbia's external position in the 2012–2017 period

Owing to the achieved macroeconomic stability and improvement of the business environment over the past six years, the Serbian economy has become more competitive as indicated by the enhancement of its external position. This is also conducive to a much more favourable growth outlook. **That Serbia's position has improved is visible in all key aspects of foreign trade:** deficit has narrowed, exports have intensively expanded along with a broader supply covering technologically more demanding products, while the most prominent in the import structure has been the purchase of equipment, followed by raw materials and intermediate goods needed for production purposes. The above, as well as the geographic distribution of trade in goods, confirm the sustainability of Serbia's external position and hence of the sources of its economic growth.

Chart O.2.1 **Balance of trade in goods with main trading partners**
(in EUR mn)



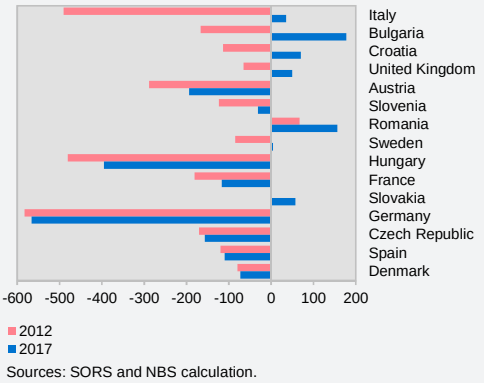
Sources: SORS and NBS calculation.

On these grounds we analysed the dynamics and characteristics of Serbia's trade with its traditionally most significant trade partners, the **EU, CEFTA[1] and Commonwealth of Independent States (CIS[2])** which together accounted for 91% of Serbia's export and 76% of its import of goods in 2017.

Serbia's trade balance with these economic groups improved by over EUR 2.6 bn in 2017 compared to 2012 (Chart O.2.1), as a result of a decrease in its trade deficit with the EU (by EUR 1.5 bn) and CIS countries (by EUR 0.6 bn), and of the higher surplus with CEFTA countries (EUR 0.6 bn). Compared to 2012, Serbia's external position improved in 2017 on the back of an increase in the volume of trade with these groups[3] (by 41.4%), supported by a much faster rise in the export of goods – by 67.2%.

Faster growth in the export of goods in 2017 was recorded **in trade with EU countries**. It went up by 85.6% or EUR 4.6 bn from 2012, and the increase was recorded in trade with all countries with the exception of Cyprus and Malta. On this account, **Serbia managed to record a surplus instead of a deficit in the trade with a number of countries** (Italy, Bulgaria, Croatia, the UK and Sweden), **to narrow the deficit** (Austria, Slovenia, Hungary, France, Germany, etc.) or **to increase the surplus** (Romania and Slovakia) (Chart O.2.2). The export of goods to CIS countries also picked up in the observed period, especially to the Russian Federation (by 30.4%).

Chart O.2.2 **Net exports to EU countries by contribution to improvement of balance of trade in goods**
(in EUR mn)



Sources: SORS and NBS calculation.

What is specific for trade with this economic group is the reduction in the value of goods import which, among other, is a result of lower crude oil prices. In addition, exports to CEFTA countries also went up (by 36.5%) in 2017, resulting in a further increase in the surplus from 2012, recorded in the trade with individual members of this group as well.

By product group, the most significant contribution to the reduction in the trade deficit with the EU in the observed period came from the increase in the trade surplus in electrical

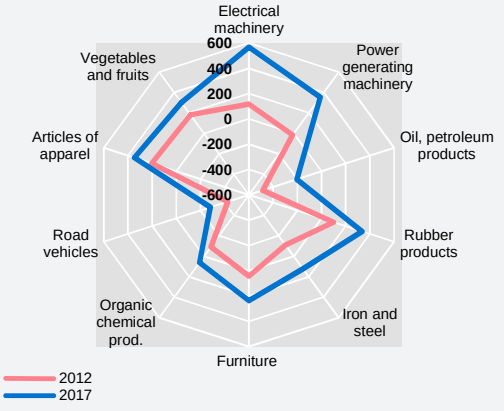
[1] CEFTA comprises Moldova and the Western Balkan countries (Serbia, Albania, Bosnia and Herzegovina, Montenegro, Macedonia). Moldova is analysed under CIS countries.

[2] CIS denotes the Commonwealth of Independent States and its members are: the Russian Federation, Armenia, Azerbaijan, Belarus, Kyrgyzstan, Kazakhstan, Moldova, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

[3] Concluded free trade agreements have reflected positively on the increase and geographic diversification of trade with the said economic groups.

machinery, apparatus and appliances, and power generating machinery and equipment by around EUR 820 mn, which makes 56% of the total improvement in Serbia's external position towards the EU. Increase in the export of these two product groups from around EUR 660 mn in 2012 to almost EUR 1,780 mn in 2017 indicates the increasing presence of products with higher technological performances in the composition of Serbia's exports. The same period also saw a pick-up in the export of vehicles to the EU by EUR 720 mn. A significant rise in the export of goods and, in turn, improvement in the external position, were also recorded for iron and steel, rubber products, furniture and furniture parts, industrial machines for general usage, nonferrous metals, fruit and vegetables (Chart O.2.3). On the other hand, imports from the EU rose by 35% on account of the purchase of vehicles, electrical machines, appliances and devices, industrial machines for general usage and unclassified goods, in accordance with the mounting importance of investment purchases. Taking the above into account, **the observed period saw a rise in the export for 57 of the total 65 groups of products**[4] **traded with the EU**. This illustrates the pronounced dispersion and the upward trend of exports supply, and of the fact that the rise in imports is driven by the purchases of equipment and the required intermediate goods for production, contributing to economic growth sustainability.

Chart O.2.3 **Net exports to the EU – top ten products by contribution to improvement of balance of trade**
(in EUR mn)



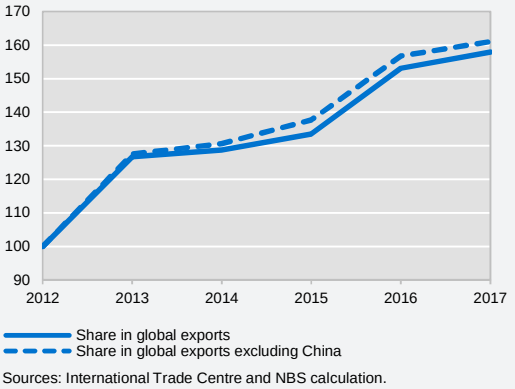
Sources: SORS and NBS calculation.

Improvement of Serbia's external position **relative to CIS countries** is mostly a result of decreased values of oil and gas imports (feeding into deficit narrowing by over EUR 620 mn) with a significant increase in the export of fruit and vegetables, paper, cardboard and cellulose products, clothing, rubber products, dairy products, industrial machines for general usage, fertilisers, etc. On the other hand, some divisions saw a slight decrease in exports, but this was offset by a strong rise in the exports to the EU in those divisions. As for the composition of imports, a considerable increase is recorded for metal ores and scrap metal, as well as plastics in primary forms (by around EUR 267 mn in 2017 relative to 2012), which is in line with the domestic producers' growing needs for raw materials in black metallurgy and chemical industry.

Serbia's **trade position with CEFTA countries** was additionally strengthened in the period under review – the export-to-import ratio rose from 277% to 324%. The most significant expansion in export and improvement of Serbia's external position was recorded for iron and steel, oil and petroleum products, road vehicles, cereals and cereal-based products, solid vegetable fats and oils, meat and meat products, etc. Of the 64 divisions which were the subject of exchange, 47 posted a rise in the trade surplus. On the other hand, deficit increased in the trade of hard coal, coke and briquette in the observed period, but it was more than fully compensated for by elevated export of iron and steel.

The improvement of Serbia's external position is also corroborated by the data on the **share of Serbia's goods exports in global exports, which rose by 58% in 2017 relative to 2012**. If China is excluded from the global export of goods, this growth amounts to 61% (Chart O.2.4). These results additionally gain in significance when taking into account that they were achieved in the face of tightening competition in the international market and current global geopolitical and trade tensions.

Chart O.2.4 **Share of Serbian exports in global exports of goods**
(in index points, 2012 = 100)



Sources: International Trade Centre and NBS calculation.

[4] Two-digit aggregation level according to SITC (divisions of the Standard International Trade Classification).

Positive tendencies in trade in goods resulted from a more favourable business environment in Serbia. This reflected on the rise in investment in tradable sectors and enhanced competitiveness of the domestic economy. Strengthened competitiveness of the domestic economy is also indicated by the latest results of the Global Competitiveness Index of the World Economic Forum for 2018, stating that Serbia made progress on this list moving up by five notches and is now ranked 65th out of 140 countries. The advancement was recorded in the area of macroeconomic stability as a result of low and stable inflation and public debt decrease, and in the financial system, owing to the NBS macroprudential policy and preserved financial stability. In addition, competitiveness also improved in the majority of other areas – the product market, the labour market, infrastructure, innovation capability. A better result in human capital (skills) and innovation eco-system, as well as health is particularly important for the rise in the production potential. According to the latest World Bank Doing Business Report, Serbia continued to approach the best global practice measured in terms of business conditions – it increased its total score from last year and is still among the first 50 countries in the ease of doing business (of the total of 190 countries), though its ranking – 48th, in relative terms, is negligibly less favourable. Here we should bear in mind that many important areas affecting the quality of the business environment and competitiveness of a country are not covered by this score, as emphasized by the World Bank in the Report. Among these we can list macroeconomic stability and financial system development, which are within the scope of NBS activities, and in which the Republic of Serbia made a significant progress.[5]

[5] The World Bank measures progress under 11 areas of business: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across border, enforcing contracts, resolving insolvency and labour market regulation.

5 Economic activity

Sustained positive developments in construction and services, driven by intense implementation of infrastructure projects and the recovery of domestic demand, with excellent results of this year's agricultural season, contributed to continued GDP growth in Q3 of 3.7% y-o-y (preliminary estimate of the Statistical Office). It is our estimate that three-month s-a GDP growth in Q3 amounted to 0.3%, which is the 14th consecutive quarter of GDP growth, also driven by the recovery in manufacturing.

We revised the GDP growth projection for 2018 upwards again, to 4.2%, as economic growth since the beginning of the year has been higher than projected in the last Report and also the highest in ten years.

Table IV.5.1 **Contributions to y-o-y GDP growth**
(in pp)

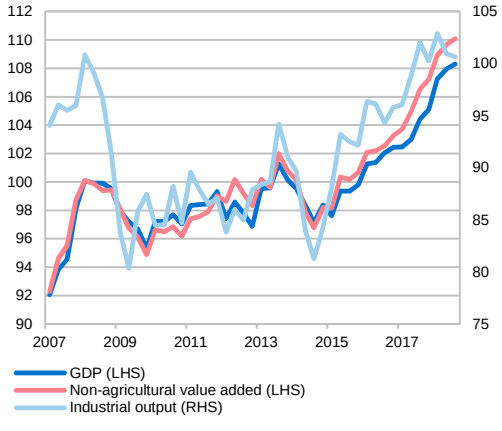
	2017		2018		
	Q3	Q4	Q1	Q2	Q3*
GDP (in %, y-o-y)	**2.3**	**2.4**	**4.9**	**4.8**	**3.7**
Agriculture	-1.2	-0.8	0.7	1.0	1.4
Industry	1.3	0.6	1.1	0.6	-0.3
Construction	0.3	0.8	0.9	1.0	0.7
Services	1.4	1.3	1.7	1.9	1.8
Net taxes	0.4	0.3	0.5	0.5	0.4

Sources: SORS and NBS calculation.
* NBS estimate.

Relatively robust GDP growth continued into Q3, amounting to 3.7% y-o-y (preliminary estimate of the Statistical Office). At the same time, growth remained widely dispersed and was **recorded in the majority of sectors**, while the largest positive contribution (1.8 pp) stemmed from services, as was also the case in the previous quarter. Activity in the agriculture and construction sectors also continued to ascend and to give a positive contribution to GDP (1.4 pp and 0.7 pp, respectively). Manufacturing output went up, too. However, Q3 saw a mildly negative contribution of overall industry to GDP (-0.3 pp) due to a temporary drop in the mining and energy sectors' output.

In quarterly terms, GDP growth was estimated at 0.3% s-a in Q3, and this was the 14th consecutive quarter of economic upturn. Compared to the pre-crisis period, economic activity in Q3 went up by 8.3% measured by GDP, or by 10.1% measured by NAVA.

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



Sources: SORS and NBS calculation.

In addition to favourable developments in construction, services and agriculture, manufacturing growth also yielded a positive contribution to GDP. However, a temporary slowdown in mining and energy brought about a reduction in the overall **industrial output** by 0.3% s-a. The rise in manufacturing was indicated by the pick-up in the physical volume of production by 1.8% s-a, coupled with a positive contribution to overall industry by 1.3 pp. The largest contribution to quarterly growth in manufacturing stemmed from the production of petroleum products, and to a lesser extent from the production of rubber and plastic products, metal products and construction material. On the other hand, the sharpest fall relative to Q2 was recorded in the production of

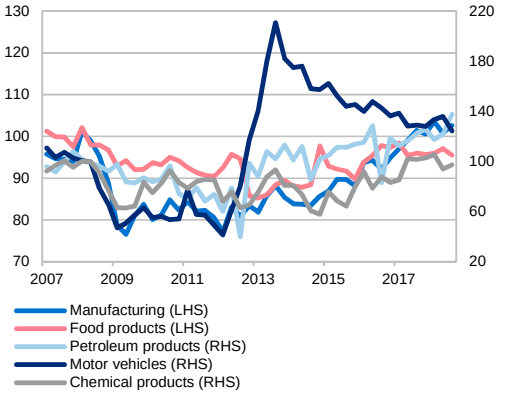
pharmaceutical products, motor vehicles and electrical equipment. **In y-o-y terms, Q3 saw the continuation of growth in the physical volume of production in manufacturing (1.1%) for the 15th consecutive quarter**. This rise provided a positive contribution to the physical volume of production of overall industry of 0.8 pp.

A temporary decline in the physical volume of production in the sectors of mining and electricity, gas and steam supply (6.6% s-a and 8.0% s-a, respectively) can be linked to capital overhauls in thermal power plants and low water levels in rivers. The temporary nature of subdued production in the said sectors is also indicated by the monthly dynamics in Q3, i.e. the fact that a decline in July and August was followed by the recovery of production in September. The drop in the physical volume of production in these sectors was also felt in y-o-y terms, partly on account of the last year's high base.

The **construction sector**, which went up by 2.7% s-a in our estimate, continued to provide a positive contribution to GDP growth (0.1 pp) in Q3, on the back of sustained acceleration of investment in infrastructure and further recovery of the real estate market. Positive developments were also suggested by an increase in the production of construction materials by 2.2% s-a, as well as a further rise in formal employment in the construction sector which in Q3 reached its highest level in six years owing to efforts made to curb the grey economy. The increasing number of issued construction permits and the projected value of the related works performed in July and August indicate that positive tendencies in construction are likely to continue in the period ahead. In y-o-y terms, the construction sector again recorded two-digit growth in Q3, which we estimate at 15.0%.

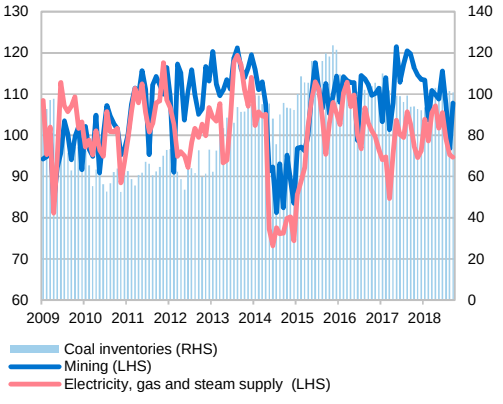
In addition to construction, a positive contribution to GDP in Q3 stemmed from the rising level of activity in the **service sectors** (0.3 pp), which cumulatively amounted to 0.6% s-a. Developments in trade also remained favourable as indicated by an increase in retail trade by 1.2% s-a in Q3, largely owing to sustained favourable labour market trends. In addition to trade, the level of activity is also rising in the sectors of services, accommodation and food as suggested by the higher number of tourist arrivals (3.3% s-a) and their overnight stays (3.8%) in Q3. Elevated level of activity in the service sectors is also indicated by the extended upward trend of employment in the majority of sectors in Q3. In y-o-y terms, the service sectors recorded cumulative growth of 3.5% in Q3 with a positive contribution to GDP growth (1.8 pp).

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



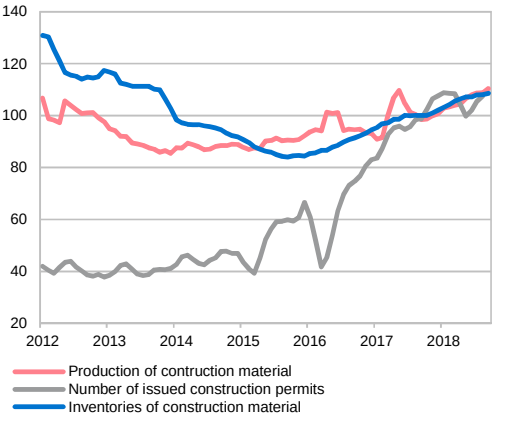
Sources: SORS and NBS calculation.

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



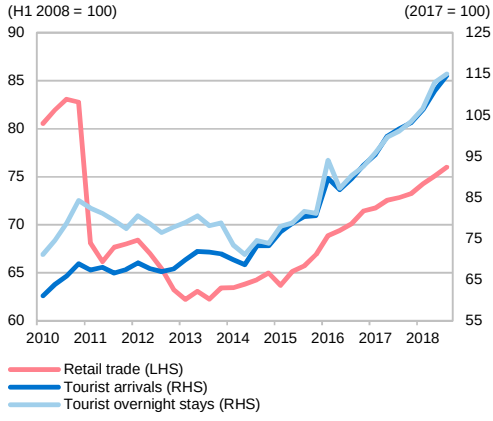
Sources: SORS and NBS calculation.

Chart IV.5.4. **Construction activity indicators**
(quarterly averages s-a, 2017 = 100)



Sources: SORS and NBS calculation.

Chart IV.5.5 **Service sector indicators**
(s-a)



Sources: SORS and NBS calculation.

Table IV.5.2 **Expected agricultural production in 2018**

Agricultural crops/plants	Cropped area (in thousand hectares)	Average yields (in tonnes/ /hectares)	Expected production in 2018 (in thousand tonnes)	Annual growth in 2018 (in %)
Wheat	648.1	4.5	2,941.6	29.3
Corn	906.8	7.7	6,964.8	73.3
Soybean	196.5	3.3	645.6	40.0
Sunflower	239.1	3.1	733.7	35.7
Sugar beet	51.3	50.3	2,583.3	2.8
Raspberries	22.4	5.5	122.3	11.5
Sour cherries	18.2	6.9	126.0	37.5
Apples	25.1	18.3	460.4	21.6
Plums	72.0	6.0	430.2	30.1
Vineyards	21.2	7.3	151.0	91.2

Source: SORS.

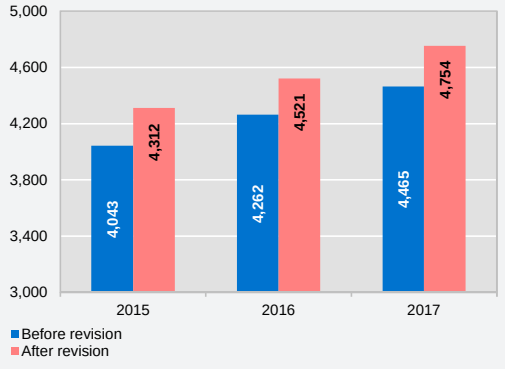
Q3 also saw **excellent agricultural output**, as suggested by the published preliminary data on the achieved yield of autumn crops. Thus the production of corn rose by as much as 73.3% relative to the year before, despite smaller cropped areas. Soybean and sunflower production also recorded a sharp increase (40.0% and 35.7%, respectively). Such developments largely reflect favourable agricultural and meteorological conditions since the beginning of the year, as well as the low base owing to the last year's drought. In addition to crops, a positive contribution to the rise in agricultural output also came from the good yield of main fruits (apples, plums, raspberries). In y-o-y terms, agricultural growth is estimated at 14%, with an expected positive contribution to GDP growth of 0.9 pp.

Owing primarily to excellent results in agriculture and construction from the beginning of the year which exceeded our past expectations, **we again revised up the 2018 GDP projection, to 4.2%**. Beside agriculture, construction should also rise at a two-digit rate of around 15% in 2018. Moreover, a further recovery of domestic demand will continue to support the rising level of activity in the service sectors, while a positive contribution, similar to last year's, should come from industry, too.

Text box 3: Revision of GDP data for the 2015–2017 period

At the beginning of October the Statistical Office published new, revised data on annual GDP and its composition on the production and expenditure side for the 2015–2017 period, announcing that by end-2018 it should publish the revised data for the period from 2005 onward, and by end-2019 the complete series from as far back as 1995.[1] The revision of GDP data included new sources of data and methodological improvements which should result in greater comprehensiveness, precision and reliability of data. Great improvement can also be attributed to the usage of data from the Central Registry of Mandatory Social Insurance which enabled a better assessment of formal employment and, consequently, a better assessment of informal employment and the grey economy. In addition, economic accounts of agriculture have entered the GDP calculation for the first time, enabling a more precise measuring of value added in agriculture. Moreover, GDP calculation in constant prices has been improved by the introduction of the industrial import price index.

Chart O.3.1 **Revision of nominal GDP**
(in RSD bn)

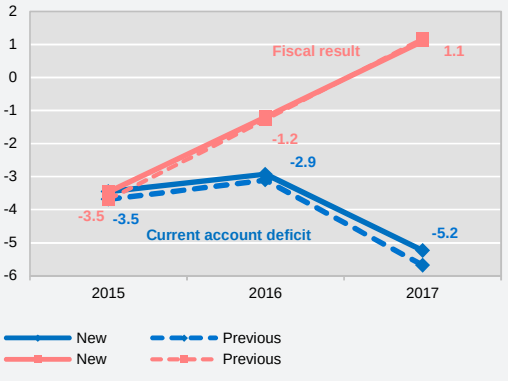


Source: SORS.

The revised data suggest a higher level of nominal GDP in every observed year in the 2015–2017 period (Chart O.3.1). Precisely, in 2017, the level of nominal GDP was higher by 6.5% or by RSD 290 bn, i.e. EUR 2.4 bn, in the absolute amount. The higher nominal GDP affected the shares of relevant macroeconomic indicators in GDP in the observed period (Charts O.3.2 and O.3.3). Thus, the share of central government public debt in GDP at end-2017 amounted to 57.9% according to new data, compared to 61.5% before the revision. Taking into account the expected payment of the eurobond from fiscal savings i.e. without new borrowing, by the end of the year, we expect the share of public debt in GDP to be at around 50% at the beginning of the next year. The share of external debt in GDP is also lower and the revised data suggest that it stood at 65.3% at end-2017 compared to the earlier 69.7%. The share of the current account deficit was also trimmed (from 5.7% to 5.2% in 2017) on account of methodological improvements in the imports calculation, in addition to the higher nominal GDP.

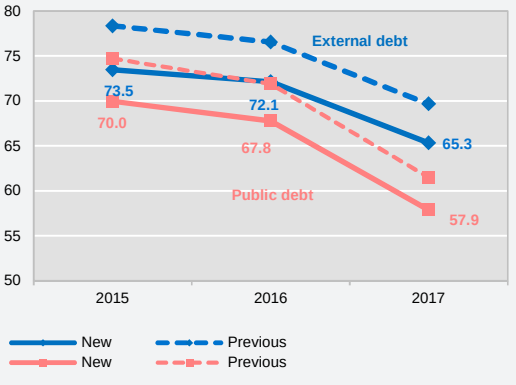
As for the real GDP dynamics, growth rates were revised upwards by 0.5 pp in 2016 (from 2.8% to 3.3%) and by 0.1 pp in 2017 (from 1.9% to 2.0%). Cumulatively, real GDP growth stood at 6.3% in the period 2015–2017 according to the

Chart O.3.2 **Revision of the macroeconomic indicators share in GDP**
(in %)



Sources: Ministry of Finance and NBS.

Chart O.3.3 **Revision of the macroeconomic indicators share in GDP**
(in %)



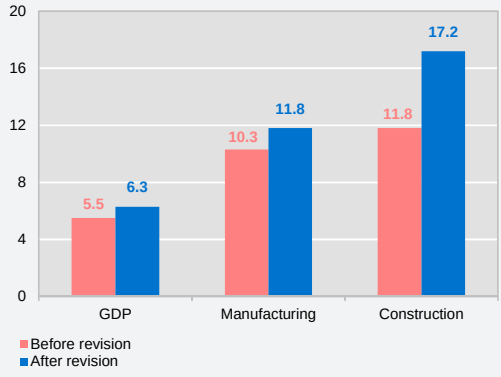
Sources: Ministry of Finance and NBS.

[1] http://publikacije.stat.gov.rs/G2018/Pdf/G20181271.pdf.

latest data, which is up by 0.8 pp relative to the data before the revision (Charts O.3.4 and O.3.5). In addition to faster real growth, the structure of growth also improved considerably and is now mainly driven by the increase in fixed investment on the expenditure side and by a higher rise in manufacturing and construction on the production side.

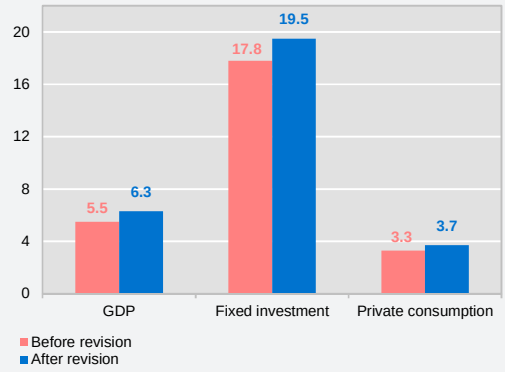
The GDP data revision suggests overestimation of external and internal imbalance indicators in the past. In terms of the indicators monitored by investors, international financial institutions and credit rating agencies, i.e. indicators used for investment decisions, country credit ratings and rankings on global competitiveness lists, the expectation is that the assessments of Serbia will be more realistic and favourable in the coming period.

Chart O.3.4 **Cumulative real growth rates in 2015–2017 – production side**
(in %)



Sources: SORS and NBS.

Chart O.3.5 **Cumulative real growth rates in 2015–2017 – expenditure side**
(in %)



Source: SORS and NBS calculation.

6 Labour market developments

Robust economic growth continued to feed into positive labour market developments through the rising demand for labour. In Q3 these developments were characterised by a sustained rise in the private sector formal employment accompanied by the rising labour force participation, lower unemployment and higher average wages in all economic sectors. At the same time, overall economic productivity also kept rising on the back of faster economic growth.

Wages and labour productivity

Nominal net wage in the private sector went up by 6.9% y-o-y in July and August as a result of sustained economic growth and higher minimum cost of labour. Coupled with the public sector wage increase of 8.5% y-o-y in the same period, which was made possible by the excellent fiscal policy results during this and the three prior years, this contributed to a rise in the overall nominal wage by 7.3% y-o-y.

The nominal net wage rose in all economic sectors indicating broad-based labour market recovery and economic growth. In addition the highest wage growth was recorded in trade, construction and accommodation and food services, followed by manufacturing, transportation and information and communications, i.e. sectors which recorded a simultaneous rise in employment. In public sector-dominated activities, wages were raised in health and social protection, education and public administration.

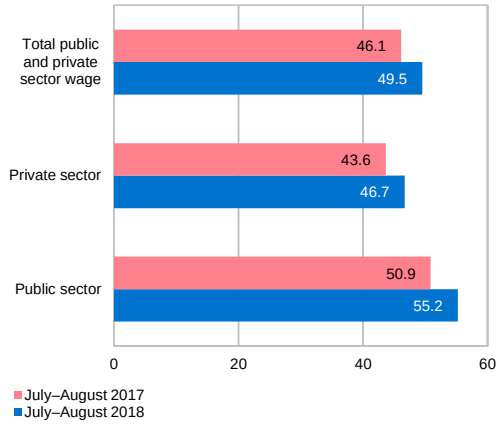
The continued rise in formal employment and increase in average wages in the corporate sector pushed the nominal wage bill up by 10.3% y-o-y in July and August.

As GDP grew faster than employment, Q3 saw a continuation of the rise in overall economy productivity, estimated at 0.4% y-o-y.

Employment

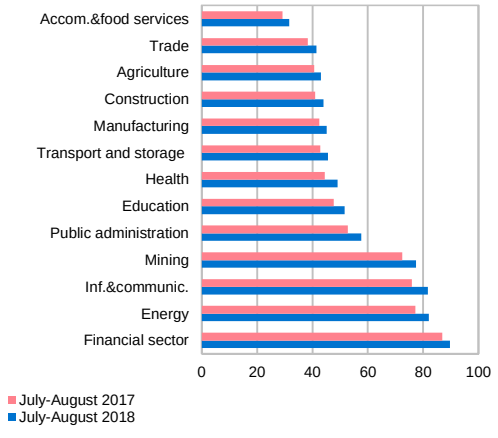
Economic growth acceleration translated into a further rise in overall formal employment, up by 3.3% y-o-y on average in Q3. According to the data of the Statistical Office obtained from the Central Registry of Mandatory Social Insurance, formal employment growth is a result of a further increase in employment with legal persons, and in the number of entrepreneurs and their employees, while the number of individual farmers continued to fall.

Chart IV.6.1 **Average nominal net wage**
(in RSD thousand)



Source: SORS.

Chart IV.6.2 **Nominal net wage by economic sector**



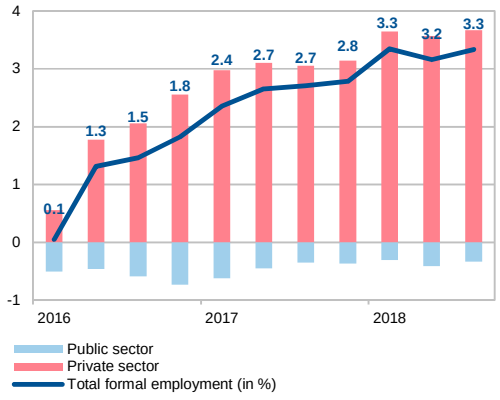
Source: SORS.

Table IV.6.1 **Movements in formal employment and unemployment**
(y-o-y growth rates, period average)

	2017	2018		
	Q4	Q1	Q2	Q3
Total number of formally employed	2.8	3.3	3.2	3.3
Employed with legal persons	2.7	3.3	3.1	3.2
Entrepreneurs and their employees	5.5	6.2	6.2	6.7
Individual farmers	-5.9	-7.3	-7.7	-8.2
The unemployed	-10.7	-10.1	-10.1	-10.5
First-time job seekers	-11.5	-10.7	-10.8	-10.9
Used to be employed	-10.4	-9.8	-9.7	-10.3

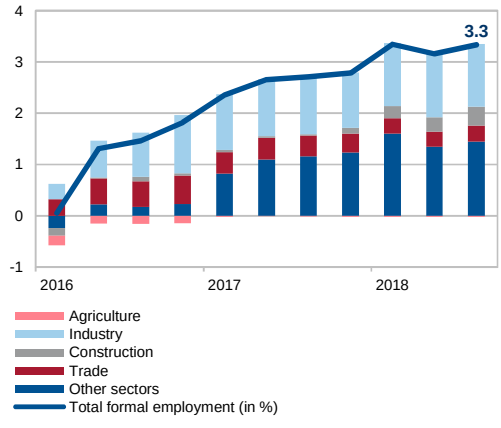
Sources: SORS and National Employment Service.

Chart IV.6.3 **Composition of y-o-y rise in total formal employment**
(in pp, period average)



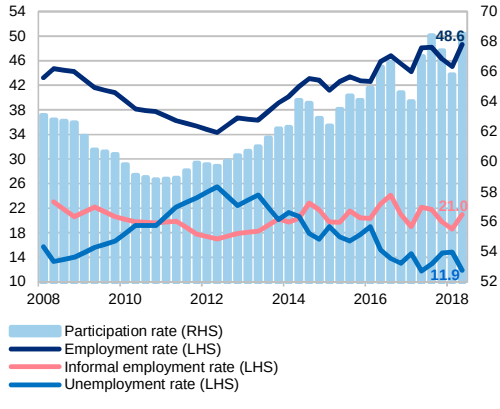
Sources: SORS and NBS calculation.

Chart IV.6.4 **Contribution to y-o-y growth in total formal employment by economic sector**
(in pp, period average)



Source: SORS and NBS calculation.

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



Source: SORS.

Formal employment growth in Q3 was still driven by private sector employment, while manufacturing recorded the most pronounced rise in y-o-y terms. Rising employment figures were recorded in the majority of economic sectors, primarily construction, trade and transportation, followed by services. In contrast, agriculture and mining saw a decline in employment, as did public administration, electricity and water supply sectors, as a result of the public sector rightsizing.

A more favourable business environment and growing recruitment needs of employers have brought unemployment further down. Implementation of active labour market policies also had the same effect.[18] According to the records of the National Employment Service, **unemployment is at its record low since comparable data are available (a quarter of the century)**, taking into account that unemployment stood at 553,962 at end-Q3, down by 69,009 relative to the same period a year earlier. In y-o-y terms, unemployment contracted across all occupational groups, with the sharpest decline recorded in manufacturing-related occupations. Furthermore, trade, catering and tourism, as well as transport and construction, also recorded a drop in unemployment which is a result of the employment increase in the said sectors. Unemployment in occupations related to agriculture, manufacturing and food processing also continued down in Q3.

Consistent with the data from the formal sources, the results of the Labour Force Survey, which covers the informal labour market developments as well, also indicate further labour market recovery. The participation rate of the working age population (15–64) stood at 68.5% in Q2, up by 1.5 pp relative to the same period a year before. Overall employment also kept increasing in Q2, by 0.5 pp to 48.6%, entirely as a result of the rise in formal employment. Favourable labour market tendencies are corroborated by the drop in the unemployment rate to 11.9%, which is close to a historic low recorded in the same period last year. In addition, long-term unemployment rate in Q2 remained unchanged from last year (7.4%), which is its lowest level since comparable data are available. The youth labour market (15–24) also recorded progress – the youth unemployment rate decreased by 1.4 pp to 27.5% in Q2.

[18] Active labour market policies entail: job matching services, career guidance and councelling, employment subsidies, support to self-employment, further education and training, special programmes for youth in transition from the education system to the labour market, etc.

7 International environment

In the period since the last Report, prospects for global economic growth were slightly revised down, therefore the outlook for the next two years is likely to remain at the last year's level of around 3.7%. Growth in the euro area, Serbia's key foreign trade partner, continued in 2018, though at a slower pace than in 2017, primarily on account of somewhat dampened external demand, which was also mirrored in its growth projection for this and the following year being slightly revised down. Relative to the July Consensus Forecast, expectations of economic growth in Southeast Europe are also a little subdued, while the projection for Serbia was significantly revised up.

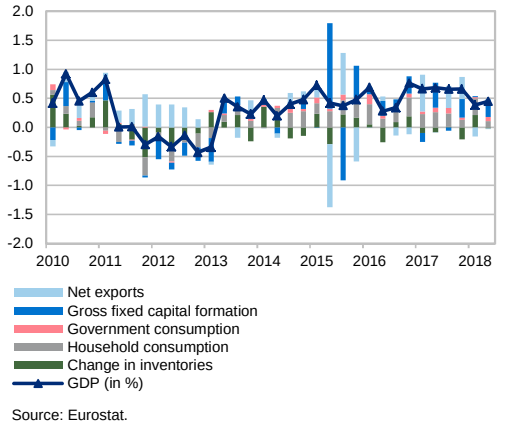
The main factor that drove inflation up in the international environment in Q3 was the higher global price of oil, however, inflation is expected to remain moderate going forward. As expected, leading central banks continued with monetary policy normalisation, while global financial conditions were slightly tightened, though still favourable. In the wake of the USA's faster economic growth and the rise in the interest rate differential between the USA and other advanced countries, Q3 saw the dollar continue to gain on other leading global currencies.

Economic activity

Global economy maintained a stable growth pace in H1 2018, although the outlook for global growth was slightly revised down in the period after the previous *Report*. Thus, in October, the IMF revised its global growth projections – it no longer expects it to accelerate (to 3.9% in 2018 and 2019), as stated in the July projection, but to remain at the last year's level of 3.7% in both 2018 and 2019. The projections were revised down in view of subdued economic activity in some of the advanced economies early on in the year, protectionism and weaker growth prospects in some emerging economies due to domestic factors, geopolitical tension, tighter financial conditions and rising oil prices.

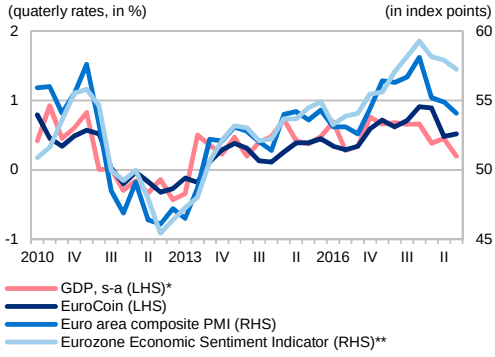
According to the ECB's estimates, **the euro area** economy continued to expand in 2018 at rates exceeding the trend, though at a slower pace than in 2017. Growth in the euro area in Q2 equalled 0.4% s-a, as in Q1, and remained broadly dispersed across countries, driven primarily by investment in fixed assets. A positive contribution also came from household consumption, precipitated by favourable developments in the labour

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



Source: Eurostat.

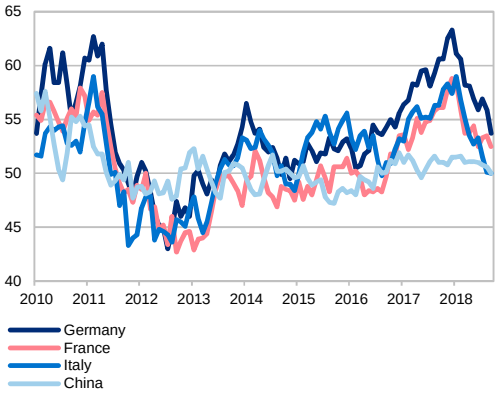
Chart IV.7.2 **Movements in GDP and economic activity indicators of the euro area**



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

* Eurostat's preliminary flash estimate for Q3 2018.
** ESI is standardised relative to PMI.

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



Source: Markit Group.

market – declining unemployment and rising wages. Deceleration in the euro area economic growth in H1 is primarily attributable to weaker external demand. As for the economic activity of Serbia's key foreign trade partners, Italy's growth slowed down to 0.2% s-a in Q2, while that of Germany accelerated to 0.5% s-a.

According to the Eurostat flash estimate, GDP growth in the euro area measured 0.2% s-a in Q3. Leading economic activity indicators, which were lower than in Q2, though still in the economic expansion zone, pointed to the slackening in economic growth. The PMI Composite for euro area on average equalled 54.3 points[19] in Q3, while the Economic Sentiment Indicator measured 111.5 points.[20] In addition, the unemployment rate in Q3 reached its lowest level since November 2008 (8.1%) and the ECB expects these favourable trends from the labour market to continue to uphold the rising household consumption.

The ECB's September projection indicates that growth will continue to be stable and broad-based going forward. Growth in the euro area for 2018 and 2019 was slightly revised down in view of the weaker external demand, by 0.1 pp to 2.0% and 1.8%, respectively, while the projection for 2020 remained unchanged at 1.7%. While the ECB underlined that risks to the projection can still be considered balanced, it estimated that risks have recently increased due to protectionism, heightened instability in global financial markets and prolonged unfavourable movements in some emerging markets.

As growth in the euro area was lower in H1 than initially expected, the IMF and Consensus Forecast revised their October projections for 2018 by 0.2 pp relative to the July forecast, to 2.0%. As for 2019, the IMF expects growth to measure 1.9%, and Consensus Forecast 1.8%, which is unchanged compared to earlier forecasts.

The USA continued to post robust economic growth in Q2, which reached the highest level in almost four years (1.0% s-a, i.e. 4.2% annualised). The major boost to growth came from personal consumption, precipitated by rising employment and wages, while the cut in the corporate income tax triggered an increase in investment. Net exports also had a positive contribution to growth, with 1.2 pp, reflecting higher orders – notably of soybean – before China's introduction of tariffs. The effect of these protectionist measures was almost the same in Q3,

[19] Index value above 50 points indicates expansion, and below 50 a decline in economic activity.
[20] The index has been designed to indicate long-term average with 100 points.

though in the opposite direction, therefore growth decelerated to 0.9% s-a (3.5% annualised), according to the Bureau of Economic Analysis. As extremely favourable developments in the labour market continued into Q3, unemployment rate in September touched its lowest level in almost 49 years (3.7%), and the number of new nonfarm payrolls stayed relatively high – at close to 200,000 per month on average.

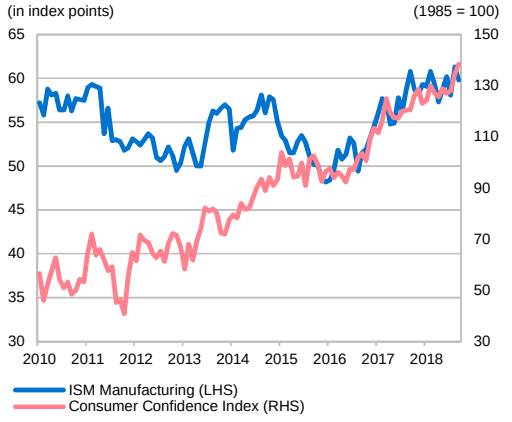
In view of the results which were better than expected, the Fed revised its economic growth expectations up in September relative to the June projection – by 0.3 pp in 2018 (to 3.1%) and by 0.1 pp in 2019 (to 2.5%). As in the June projection, it expects growth to decelerate to 2.0% in 2020 and to 1.8% in 2021 due to the exhaustion of the effects of the fiscal stimulus, monetary policy normalisation, etc. According to the October Consensus Forecast, the US economic growth is expected to measure 2.9% in 2018 and 2.6% in 2019, which is unchanged from the July forecast. The IMF kept its US growth forecast in October at 2.9% for 2018, while the figure for 2019 was revised down by 0.2 pp relative to July, to 2.5%.

Growth in the **Central European region** in Q2 was chiefly driven by domestic demand due to low unemployment, favourable sources of financing and utilisation of EU funds. According to the October Consensus Forecast, the downward revision of global growth did not reflect on expectations in terms of growth of the Central European region in 2018 given that uncertainty from the international environment was largely offset by the rise in domestic demand. Relative to the July forecast, growth in Central Europe was revised up by 0.1 pp – to 4.2% in 2018 and 3.5% in 2019. Deceleration of economic growth in 2019 is in line with the anticipated developments in the euro area and the consequently lower external demand.

According to the October Consensus Forecast, growth in the **Southeast European region** was slightly revised down from July (by 0.1 pp) to 3.5% for 2018 and to 3.3% for 2019, mostly in response to the economic downturn in Romania, following a period of robust growth in 2017. The forecast for Serbia was revised up significantly, from 3.4% to 4.1% for 2018 and from 3.2% to 3.4% for 2019.

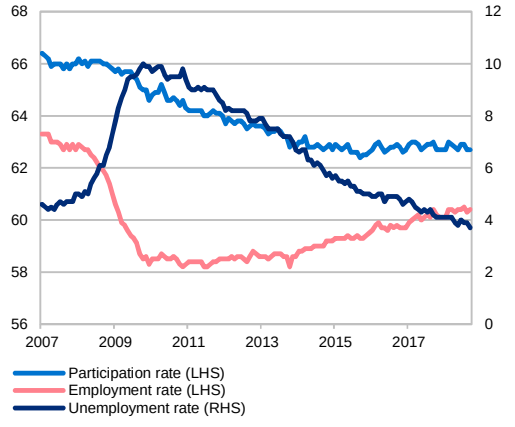
Economic growth in the majority of **Western Balkan** countries picked up the pace in H1, mainly on the back of private consumption triggered by favourable developments in the labour market, as well as of continued investment growth. According to the latest World Bank report, growth projections for the majority of Western Balkan countries were revised up relative to

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



Source: Institute for Supply Management, Conference Board.

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



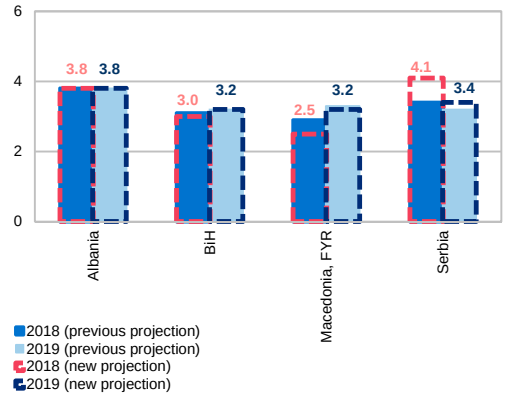
Source: Bureau of Labor Statistics.

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

	July 2018		October 2018	
	2018	2019	2018	2019
Poland	4.4	3.5	4.7	3.6
Czech Republic	3.4	3.0	3.1	3.0
Hungary	4.1	3.1	4.3	3.2
Albania	3.8	3.8	3.8	3.8
Bulgaria	3.7	3.4	3.6	3.4
Bosnia and Herzegovina	3.1	3.2	3.0	3.2
Macedonia	2.9	3.3	2.5	3.2
Romania	4.0	3.5	3.7	3.3
Slovenia	4.5	3.6	4.4	3.5
Croatia	2.6	2.7	2.7	2.7

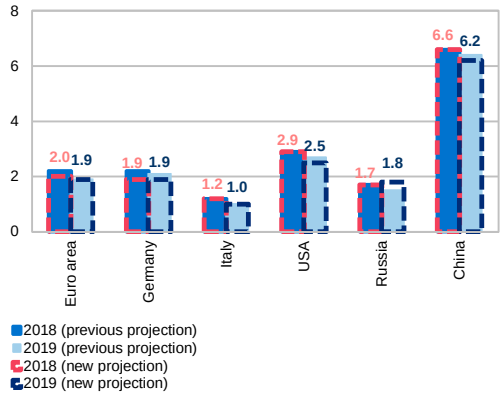
Source: Consensus Forecast.

Chart IV.7.6 **Revised forecasts for real GDP growth in Western Balkan countries for 2018 and 2019**
(in %)



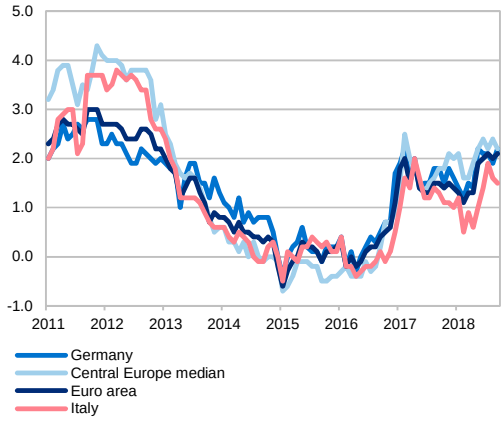
Sources: Consensus Forecast.

Chart IV.7.7 **IMF's revised forecast for real GDP growth for 2018 and 2019**
(in %)



Sources: IMF WEO Update (July 2018) and IMF WEO (October 2018).

Chart IV.7.8 **HICP across selected countries**
(y-o-y rates, in %)



Source: Eurostat.

April, hence the region is expected to post growth of 3.5% in 2018.

Russian economic growth, driven by the industrial upturn, sped up from 1.3% to 1.9% y-o-y in Q2. Since a good portion of Russia's budget income comes from the export of oil and gas, increase in the price of oil helped boost the resilience of the Russian economy to geopolitical tensions. The Consensus Forecast and IMF projections for 2018 are the same as in July – 1.8% and 1.7% respectively, indicating the highest growth in five years. According to Consensus Forecast, growth in 2019 was revised up relative to July – from 1.8% to 1.6% – due to new US sanctions, while the IMF's projections were revised up – from 1.5% to 1.8% – on account of the anticipated recovery in domestic demand and the higher oil price.

China's GDP grew at the rate of 6.5% y-o-y in Q3, which is below the rate from Q2 (6.7% y-o-y) and the lowest growth since Q1 2009. The slackening is attributed primarily to subdued investment in infrastructure projects, which is in accordance with the necessity to rebalance the Chinese economy from investment to consumption. The IMF retained its forecast of China's economic growth for 2018 at 6.6% and trimmed the projection for 2019 from 6.4% to 6.2% in view of the effects of the recently introduced tariffs, which are expected to be partly offset by the government's incentive packages. In addition to dampened external demand, growth is expected to slow down in 2019 on account of the required regulatory tightening in the financial sector.

Inflation movements

Average y-o-y inflation in the **euro area** increased from 1.7% in Q2 to 2.1% in Q3, thus reaching its highest level since end-2012, primarily owing to the rising global oil price and higher prices of food. Unlike headline inflation, core inflation remained almost unchanged and averaged 1.0% y-o-y in Q3, compared to 0.9% y-o-y in Q2. Yet, the ECB estimated that core inflation was on the upward trajectory, owing to the effects of accommodative monetary policy, continued economic growth and improved conditions in the labour market. The conditions improved in the wake of unemployment decrease and signing of an agreement on wages in some of the countries, which was mirrored in wage growth across sectors that is expected to continue in the coming period. As for Serbia's main foreign trade partners, the average y-o-y inflation, measured by the Harmonised Index of Consumer Prices (HICP), rose from 1.9% in Q2 to 2.1% in Q3 in Germany, and in Italy it went from 1.0% to 1.7%,

posting a slowdown since August, after three months of growth.

The ECB expects headline inflation to remain relatively stable going forward. September projections were not changed relative to June, therefore inflation is still expected to measure 1.7% throughout the projection horizon. The October survey of professional forecasters[21] expects stable inflation growth in the coming period, also at 1.7% in 2018, 2019 and 2020, the same as in the July survey. Long-term inflation expectations, which refer to 2023, were kept at 1.9%. Long-term market expectations, as well as long-term expectations obtained through the survey, remained stable and measured 1.67%[22] at end-October.

Among **countries in the region**, average y-o-y inflation in Q3 ranged from 1.6% in Macedonia to 4.9% in Romania. Relative to Q2, inflation in Q3 was higher in Bulgaria, Bosnia and Herzegovina and Macedonia, while in Romania it decreased after reaching a five-year maximum, as did inflation in Montenegro. Croatia noted no change in inflation. Though still below target and averaging 3.0% y-o-y, inflation in **Russia** rose during Q3 due to the depreciating rouble and the announced VAT increase. As the lira continued to depreciate, inflation in **Turkey** edged up to 19.4% y-o-y on average in Q3, and in September it reached its 15-year record (24.5% y-o-y).

Measured by the personal consumption expenditure price index, inflation in the **USA** equalled 2.2% on average in Q3, or 2.0% (the same as in Q2) excluding the prices of food and energy. The key factors affecting the rise in inflation in the past period were present in Q3 as well – rising oil prices and increase in employment, the real disposable income and consumer confidence. FOMC members estimated that inflation movements are in line with expectations and consistent with maintaining inflation within the symmetric inflation target during the projection horizon. There were no major changes to the September projection relative to June, therefore inflation at end-2018, measured by the personal consumption expenditure price index, is expected to be at the target 2%, or slightly above it, and to remain there until end-2021. Measured by the CPI, after equalling 2.7% y-o-y in Q2, inflation averaged 2.6% y-o-y in Q3.

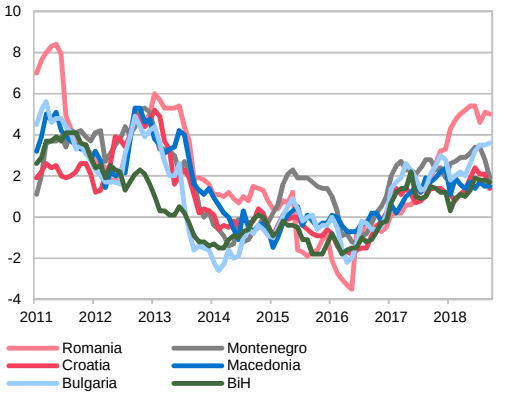
Monetary policy

According to the ECB estimate, though slower since the start of the year, when compared to 2017, economic

Chart IV.7.9 **Long-term inflation expectations in the euro area***
(y-o-y, in %)

Source: Thomson Reuters.
* Five-year, five-year breakeven forward.

Chart IV.7.10 **Movement in the Consumer Price Index for selected countries**
(y-o-y, in %)

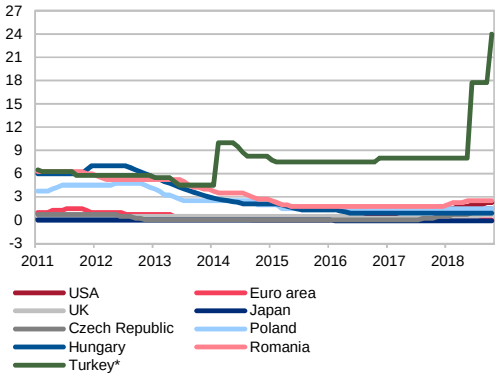


Sources: Statistical offices in several countries.

[21] ECB Survey of Professional Forecasters (SPF).

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

Chart IV.7.11 **Policy rates across selected countries**
(p.a., in %)



Sources: Central banks of selected countries.

* As of June 2018, after a year and a half, the one-week repo rate is again the key policy rate.

growth in the euro area will continue to contribute to the gradual inflation rise even after the QE programme is wrapped up. In September and October the ECB reiterated that monetary incentives are still needed, which implies net asset purchases of EUR 15 bn a month until end-year, when the programme is scheduled to end, reinvestment of the principal payments from maturing securities purchased under the QE programme for an extended period beyond end-2018, as well as guidance on the anticipated movement of ECB interest rates. In this regard, the ECB confirmed its June expectation that the rates would remain record-low at least through the summer of 2019, and in any case for as long as necessary to ensure a sustainable movement of inflation towards the ECB target of below, but close to 2%.

As expected, FOMC members passed a unanimous decision in September to raise the **Fed's** interest rate by 25 bp to 2.00–2.25% for the third time since the start of the year. The Fed expects its interest rate to continue to rise gradually in an environment of strong economic growth, favourable labour market developments and inflation trending close to the target. Relative to June projections, there are more members who expect another federal funds rate hike before the end of the year. Three interest rate increases are expected in 2019 and one in 2020.

The Fed stated it would continue normalising its balance sheet, noting that reinvestment of principal payments was reduced by USD 40 bn in September, and as of October it will be trimmed by USD 50 bn a month.

Domestic factors, notably the accelerated economic growth and wage increase, combined with the rise in global oil prices, dictated the further rise in inflation pressures in some countries of **Central and Southeast Europe** and a cautious increase in their interest rates during Q3.

Reflecting analysts' expectations, the Czech central bank lifted its interest rates twice in Q3 – the key policy rate by a total of 50 bp to 1.5%, the lending facility rate also by 50 bp to 2.5% and the deposit facility rate by a total of 45 bp to 0.5%. Since the cycle of monetary policy tightening began in 2017, the key policy rate underwent six increases, four of them in 2018. Past monetary policy tightening is attributable to inflation rising more than had been expected and overshooting the target due to a strong increase in wages and the weakening of the koruna to the euro in the previous period. In its meeting on 1 November, the Czech central bank raised its key policy

rate by another 25 bp to 1.75%, the lending facility rate to 2.75% and the deposit facility rate to 0.75%.

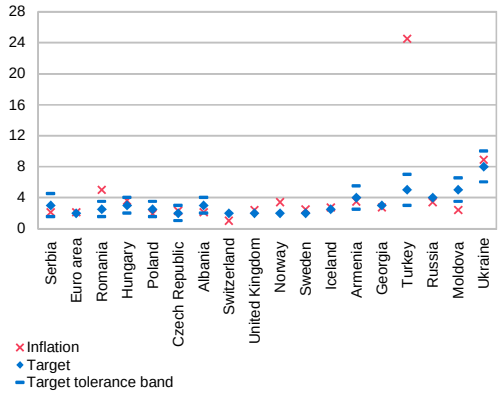
After lifting its key policy rate three times in H1, in order to stall inflation growth triggered by the dynamic economic upturn, the Romanian central bank kept its rate on hold in Q3 (2.5%). Though inflation in Romania is currently trending above the target, slightly poorer economic performance and tightened monetary conditions led to the downward revision of inflation projection, which now states that until the end of the year, inflation will slide down to 3.5% – the upper bound of the target tolerance band.

The monetary policy of the Hungarian central bank is still accommodative, with the key policy rate unchanged during Q3 (0.9%). Still, monetary policy makers voiced their readiness to gradually and cautiously normalise monetary policy, though not specifying when they would begin to do that. In order to simplify monetary policy tools, the Hungarian central bank announced that it would also gradually phase out its three-month deposit facilities, after which process the required reserve would become the main monetary policy instrument. The central bank of Poland kept its key policy rate at 1.5%, where it has stood since March 2015.

Contrary to expectations, the central bank of Turkey did not change its key policy rate in July. However, it lifted it by 625 bp to 24.0% in September, exceeding the expectations of analysts. The decision to do so was made in conditions of high inflation rise, precipitated mainly by the weakening lira. In order to mitigate the depreciation of the national currency, the Turkish President signed a decree requiring the exclusive use of the lira in all real estate transactions.

For the first time since 2014, the Russian central bank raised its key policy rate in September – by 25 bp to 7.50%, and kept it there in October as well. The statement from the October meeting said that in the short run, inflation might overshoot the target given the rouble's weakening in the past period and the impact of the announced VAT increase, which is to come into effect early in 2019, on inflation rate and inflation expectations. In order to alleviate the pressures leading to the depreciation of the rouble, the Russian central bank decided to halt all FX purchases until end-2018.

Chart IV.7.12 **Inflation and target by country in September 2018**
(p.a., in %)

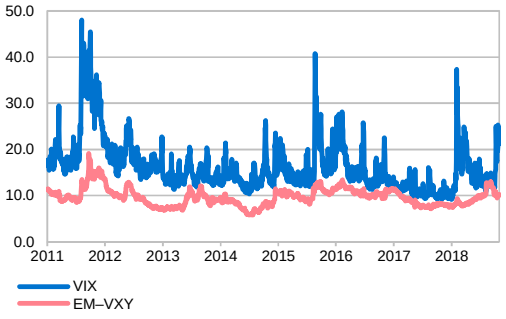


Sources: Eurostat and websites of central banks.

Financial and commodity markets

The implicit measure of **financial market volatility** (VIX) stood at a relatively low level during summer, but as

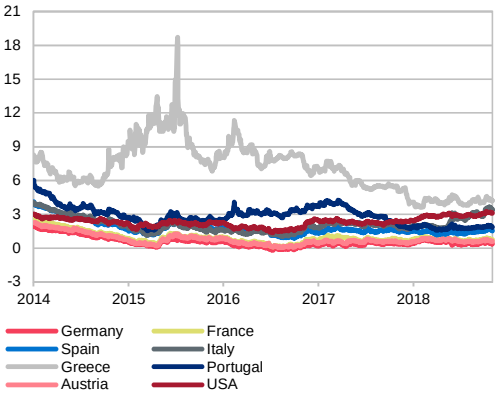
Chart IV.7.13 **Implied volatility of the global financial market***
(in %)



Source: Bloomberg.

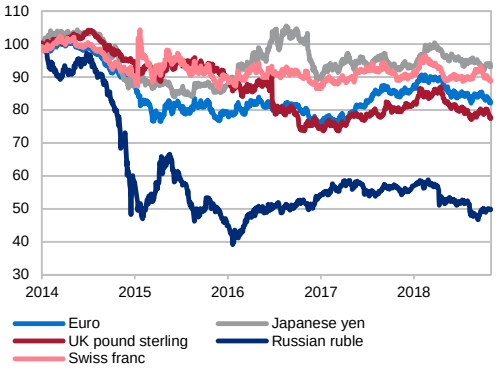
* VIX (Chicago Board Options Exchange Market Volatility Index) measures implied volatility of the S&P 500 index; EM-VXY (JPMorgan emerging markets implied volatility index) measures aggregate volatility of emerging market currencies based on three-month forward options.

Chart IV.7.14 **Yields on ten-year bonds of selected countries**
(daily data, 31 December 2013 = 100)



Source: Bloomberg.

Chart IV.7.15 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



Source: IMF.

* Growth indicates appreciation.

of early October it posted the highest growth since February, coming at 25%, only to dip to 21% by the end of the month. To a degree, the increase in volatility can be attributed to elevated apprehension over rising borrowing costs, wages and prices of raw materials, which will affect the profitability of US corporates. The continued deepening of trade squabbles between the USA and China is the source of yet more concerns for markets. The crises in Argentina and Turkey, elections in Brazil and the above-mentioned rise in trade tensions resulted in the higher volatility of currencies of emerging countries. Measured by EM-VXY, volatility reached 13% in Q3. However, according to this index, it then dipped to 10.4% at end-September, slightly above the end-June figure (9.8%).

Amid budding expectations that monetary policy normalisation in the USA will be faster than initially anticipated, as well as in view of relatively better prospects for the growth of the US economy than that of the euro area, the spread between the yields on ten-year US Treasuries and German government bonds touched a new maximum in Q2 (2.6 pp) after several decades, and hovered around that figure during Q3 as well. At the same time, yields on ten-year US Treasuries edged up 0.2 pp in Q3 (to 3.1%) and 0.5% on German bonds with the same maturity. As for EU countries, Q3 saw the highest increase in the yields on Italian government bonds (by 0.5 pp) due to political uncertainty, hence the difference in the yields on Italian and German bonds, which are considered safe assets, edged up to 2.7 pp.

Solid data in the real sector and the labour market in the USA, as well as the ongoing normalisation of the Fed's monetary policy, led to the **continued strengthening of the dollar against most of the leading world currencies in Q3**. The Swiss franc was the only one to gain on the dollar, thereby significantly making up for its weakening in H1. Although movements in the value of **the dollar to the euro** showed volatility in Q3, which was additionally heightened by the uncertainty of Brexit talks, at the quarterly level it did not change significantly (the dollar gained 0.7% to the euro). Throughout October the dollar remained largely unchanged, with the EUR/USD exchange rate at around 1.15. In the wake of the stronger dollar, the price of gold continued to decline in Q3 as well (by 5.1%).

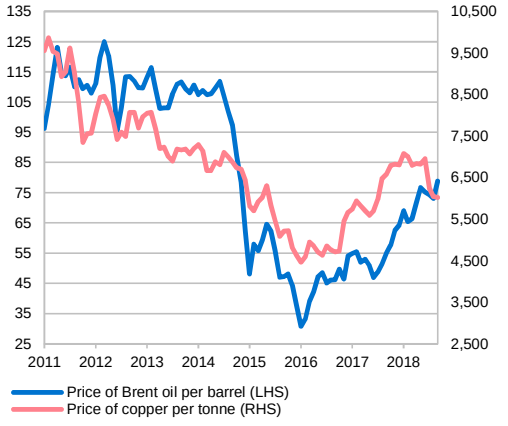
The global oil price was volatile during Q3, ranging from USD 70 to USD 83 per barrel. Observed at the end of the period, it was 5.5% higher than in Q2. In the first half of the quarter, the oil price trended down amid fears that trade quarrels would exert a significant drag on global economic growth, thereby dampening oil demand. Another factor pushing the price of oil down was the June

agreement between OPEC members and other oil exporters to gradually increase production as of July. However, while some countries, including Saudi Arabia, Libya and Russia, did increase their production, the output continued to decline in Venezuela and Angola, driving the price of oil upwards again as of mid-August. Also, the impending US sanctions on Iran drove oil price up to a new maximum in almost four years – at end-September it gained 47% y-o-y. Early in October the price of oil continued to rise, reaching USD 86 per barrel, only to edge down to USD 74 per barrel at the end of the month. This means that October saw the price of oil post the biggest monthly fall since July 2016, under the impact of both higher supply (due to the stepped-up production in Saudi Arabia and the USA) and lower demand in the global market (due to the slowdown in global economic growth).

Based on the World Bank's primary commodities' price index, the **prices of metals and minerals** dropped by 11.0% in Q3, mainly in response to weaker global demand and uncertainty associated with the possible impact of trade tensions on China's economic growth. Once the demands posed by unions of Chilean miners were met, the production in the world's biggest copper mine was increased, triggering a fall in the price of copper to the lowest level since July 2017. After posting a rise in H1, the price of aluminium dropped in Q3. Ever since the start of the year, the price of aluminium recorded a volatile trend due to the uncertain supply of the aluminium ore, US sanctions against the Russian aluminium producer and trade tensions. Only the price of the iron ore, which is the main input for the steel industry, increased as of July, despite weaker prospects of global economic growth.

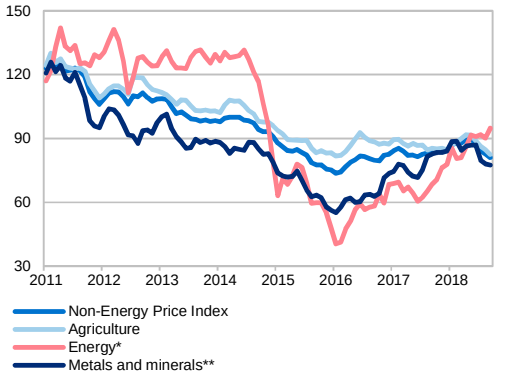
Measured by the FAO index, **world food prices** fell by 4.2% in Q3 under the contribution of all food products included in the index. Though still up by 8.8% y-o-y, the price of cereals reversed its growth trend from H1, chiefly in response to the good corn harvest in the USA and increased global supply, as well as the higher wheat exports from Russia. The price of vegetable oil fell to its lowest level in three years (-20.9% y-o-y) on account of large inventories of palm oil in major exporting countries and the increased sunflower oil supply in the Black Sea region. The price of sugar was down by 20.4% y-o-y at end-Q3, its lowest since early 2009, while the price of dairy fell 13.9%, after oscillating significantly over the past year. Of the remaining food products in the FAO index, the price of meat remained largely unchanged in Q3, dipping 3.7% y-o-y at the end of the quarter.

Chart IV.7.16 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

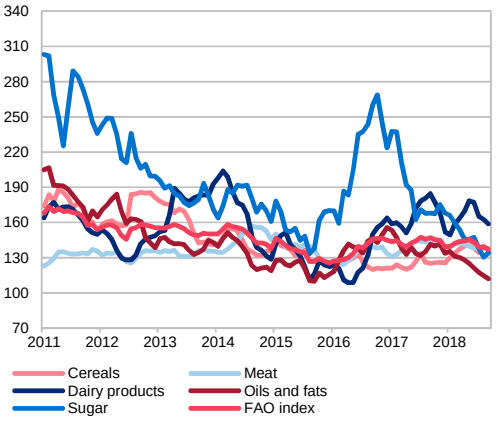
Chart IV.7.17 **Primary Commodity Prices Index**
(2010 = 100)



Source: World Bank.

* Crude oil, natural gas and coal.
** Copper, aluminium, iron ore, lead, nickel, zinc, steal and tin.

Chart IV.7.18 **World Food Price Index**
(in real terms, 2002−2004 = 100)

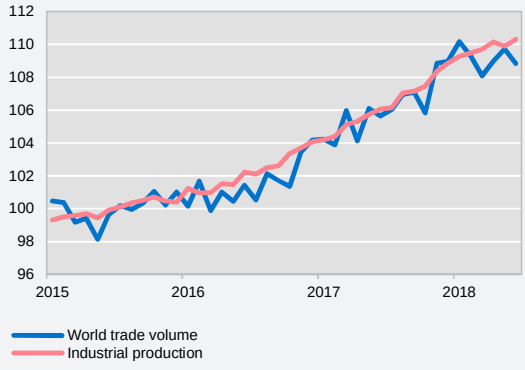


Source: UN FAO.

Text box 4: Rising trade tensions and their impact on global economic developments and Serbia

Following several decades of global trade liberalisation, a turn has been made this year with the introduction and threat of new tariffs by the USA and the retaliation of the affected countries (China, Canada, Mexico, the EU, India, Turkey, Russia). Nevertheless, economic impact of the initial trade conflict has been confined, with the exception of specific sectors, as corroborated by the data on global trade dynamics since the beginning of the year – though growth rate slackened relative to 2017, which saw one of the highest real growth rates in the post-crisis period (4.6%), it is still relatively robust (4% y-o-y in H1). Global economy is still posting a steep rise despite exposure to risks.

Chart O.4.1 **World trade volume and industrial production**
(index, 2015 = 100)



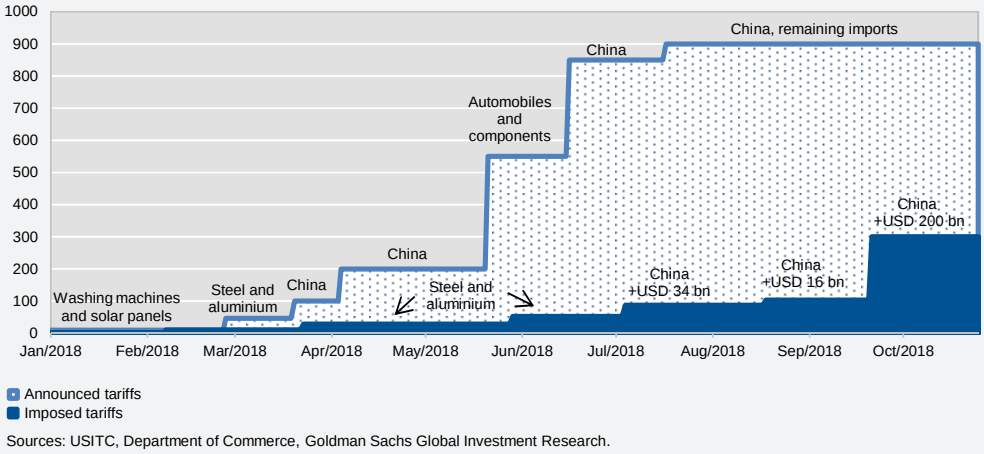
Source: World Economic Outlook, October 2018.

Though past protectionist measures did not have serious adverse effects, the possibility of escalating trade tensions has become one of the main risks to macroeconomic projections mandating caution in the pursuit of monetary policy by central banks, including the NBS. The magnitude of these risks is emphasised by the fact that it is hard to judge the direction and the scale of the future measures, including the effects of the spreading protectionism, as the transmission mechanism of this shock is extremely complex.

Early this year the USA first introduced steep tariffs on the import of solar panels (30%) and washing machines (20%), affecting mostly China and South Korea. This was followed by the imposition of additional tariffs on the import of steel (25%) and aluminium (10%), as well as the retaliatory measures of exporting countries, including the EU. Then the USA imposed additional tariffs on the import of goods from China, to which China responded with retaliatory measures. A segment of trade hit by the protectionist measures expanded more considerably in September with the new wave of tariffs which the USA imposed on the import of Chinese products. China announced retaliatory measures and the USA said it would introduce new tariffs in that case, burdening the overall imports from China with additional tariffs (Chart O.4.2).

Stressing the reduction in the trade deficit and the protection of intellectual property of American companies as the priority of its trade policy, the USA has imposed tariffs on around USD 300 bn worth of imports so far (according to data on imports in 2017). It also announced possible tariffs for additional USD 600 bn worth of imports, including cars and

Chart O.4.2 **US imports affected by imposed and announced tariffs**
(in USD bn)



Sources: USITC, Department of Commerce, Goldman Sachs Global Investment Research.

car parts. The imposed and announced measures are largely aimed at trade with China with which the USA has the largest and increasing deficit. It amounted to USD 375.2 bn (out of USD 796.2 bn of total deficit) in 2017, up by 8.1% from 2016.

From the perspective of the possible impact on global trade it is important to stress that additional tariffs on all countries covered 2.5% of total flows so far and if the USA imposes all the measures it has announced so far, that share could increase to around 4%.

If the rise of protectionist measures were largely limited to the USA and China, and the measures imposed and announced so far mostly do relate to them, the question arises as to what the repercussions would imply for these two countries, third countries and the global economy. Since trade protectionism affects prices, economic activity, employment, wages and profit, the consequences would be complex and difficult to anticipate.

There is an almost full consensus among economists that deepening of the US-China trade conflict would reflect negatively on both economies, particularly the sectors of electronic equipment, machines and agriculture. The costs of adjustments will depend on how well the exporters (i.e. importers) in affected countries are able to find alternative sales markets (i.e. supply markets) under unchanged market conditions. Thus, for instance, the reduced US demand for Chinese products will force exporters to seek alternative markets, but it is highly unlikely that they will find them under unchanged market conditions, which will then decrease their profitability, output, employment and investment. It is also highly improbable that Chinese retaliation, i.e. strengthened protection of the domestic market from US imports, will be able to offset these losses. China responded to the possible slack in exports and economic activity by monetary policy easing and the domestic currency depreciation which should alleviate the adverse effects of US import tariffs.

Higher tariffs could lead not only to the decrease in exports of the country against which they were imposed, but also to reduced exports of the country imposing them. The rising US protectionism could shift the demand towards domestic companies, which it aims to do anyway, but it is difficult to estimate the scale and timing of effects. The consequences of an import shock will depend on how well the imported products compete with the domestic products and on the availability of the capacity. If domestic and imported goods cannot be directly substituted, which often is the case with highly specialised products, there is no substitution effect between the domestic and foreign products, at least not in the short and medium run, which results in a push-up effect on their prices. In case of consumer goods, this affects consumers and, in case of manufacturing products, it reduces the competitiveness of domestic companies, with possible negative effects on their exports and economic activity. Moreover, rising prices might mandate a monetary policy response which would lead to faster growth in interest rates and appreciation of the dollar, additionally weighing on exports, output and employment.

Higher tariffs in US-China trade may also weigh on the external position of third countries. On the one hand, if the USA and China traded less with each other they might intensify trade with third countries whose exports would become more competitive both in the USA and China. Furthermore, third countries might gain more favourable import conditions as they would have a better market position. However, third countries might also be hit negatively by the higher tariffs in US-China trade to the extent of their companies' integration in value chains of products traded between the USA and China, which can be upset by the escalation of trade tensions. Since the net effect on third countries is uncertain, it depends on their connection with the economies applying trade restrictions.

The escalation of trade conflict involving a much greater number of countries would have negative effects globally. Almost without exception, international institutions have been arguing this for quite some time, emphasizing that restrictions on international trade reflect negatively on productivity and hence on global economic growth both in the short and medium term. Under different assumptions, i.e. hypothetical scenarios, international institutions estimated the impact of the rising protectionism on global economic growth. OECD[1]estimates that if every country were to raise tariffs to their maximum levels without breaching the agreements with the WTO, global trade would fall by USD 809 bn and global GDP by 0.65%. JP Morgan[2] estimates similarly that if all the protectionist measures announced by the USA were applied and

[1] OECD, Trade, Policy and Economic Crisis, May 2010.

[2] JP Morgan, Global Data Watch, June 2018.

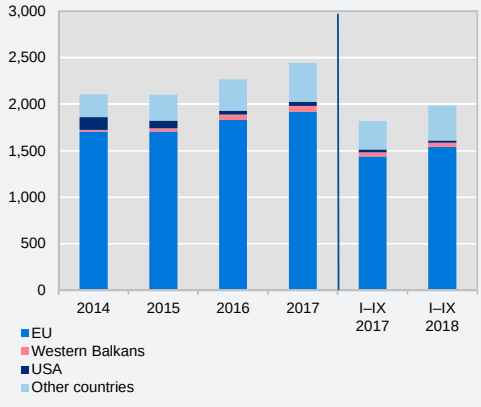
other countries retaliated, global GDP would go down by 0.4%. Illustrative simulations of the ECB[3], IMF[4] and Bank of England[5] run under the assumption that tariffs on entire US imports would be higher by 10 pp and that the countries affected would retaliate in the same way, vary and indicate that global GDP might be lower by 0.5–1%. Nevertheless, for the time being this scenario is highly unlikely. As emphasized by the IMF, the risks are pronounced and global economic growth prospects were revised down in October (by 0.2 pp), but this growth remains robust (3.7% in this and the coming year). Among the factors that made the prospects less favourable than six months ago, the IMF states rising protectionism, but also less favourable global financing conditions, geopolitical tensions and global oil price hike.

There is a general consensus among analysts that the downside risk to global growth might increase if the escalation of trade tensions undermines business sentiment, denting investment and consumption. Protectionism relies on discretionary decisions, which makes business and investment riskier and the global growth outlook weaker. The financial markets' response might additionally strengthen these negative effects. Nevertheless, the protectionist measures have not seriously shaken the confidence of American corporates so far. The S&P 500 Index indicates that optimism about the largest world economy has more than outweighed the concerns about protectionism.

Potential impact on Serbia. Trade restrictions and their direct and indirect effects on Serbia have been negligible so far. The US protectionist measures have directly hit only Serbia's steel exports and even this impact has been limited. Around 1.3% of Serbia's exports go to the USA, of which only 0.2% relating to steel. The bulk of iron and steel was exported to EU countries (over 70%) – Italy, Bulgaria, Austria, Hungary, Germany and the Czech Republic, while 15% was exported to neighbouring countries (Macedonia, Bosnia and Herzegovina and Montenegro) and 3.2% to the USA. If the USA imposes tariffs on motor vehicles, the direct effects on Serbia will also be modest as our exports of motor vehicles to the USA are not large (around 0.1% of total Serbia's exports). Still, the potential impact might be indirect due to reduced exports of domestic companies manufacturing car components for leading global car producers (which together with car exports account for 16% of total Serbia's exports). The bulk of Serbia's exports of car components targets the EU market, and the EU sold motor vehicles on the US market last year worth USD 38 bn or 8.7% of total EU exports to the USA.

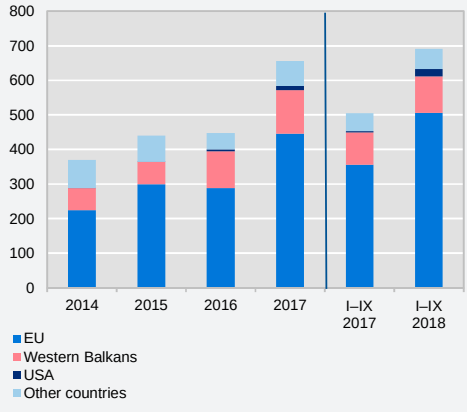
The potential indirect influence of protectionist measures on Serbia might stem from the potential EU and euro area economic slack which might cause a slowdown of the Serbian economy, through the export demand channel. Complex trade relations between the EU and the USA and China undermine the forecasting of the effects on the EU even in the case

Chart O.4.3 **Automobile industry exports from Serbia**
(in EUR mn)



Sources: SORS and NBS calculation.

Chart O.4.4 **Steel and iron exports from Serbia**
(in EUR mn)



Sources: SORS and NBS calculation.

[3] The Consequences of Protectionism, speech given by Benoît Cœuré, member of the Executive Board of the ECB, at the workshop "The Outlook for the Economy and Finance", 6 April 2018.

[4] Lindé, J. and Pescatori, A. (2017), "The Macroeconomic Effects of Trade Tariffs: Revisiting the Lerner Symmetry Result", IMF Working Paper, 17/151.

[5] From Protectionism to Prosperity, speech given by Mark Carney, governor of the Bank of England, Northern Powerhouse Business Summit – Great Exhibition of the North, 5 July 2018.

that trade tensions between the USA and China remained largely bilateral. It is estimated that the EU could benefit from this situation, on the one hand, since its companies are specialised in manufacturing of over half of manufacturing categories to which the tariffs refer, which qualifies them for filling in the gaps in the US and Chinese markets.[6] How successful they will be depends on the possibility to substitute the products affected by the tariffs. On the other hand, it is estimated that a portion of products from China and the USA hit by the bilateral tariffs might end up in the European market. This would exert downward pressure on the prices and profitability of European companies and thus cause the postponement of some decisions to invest in production. Moreover, a negative effect on the EU might also emanate from lower investment in the USA and China which would cause the demand for capital goods from the EU to fall. In any case, the effects would differ by sector and EU country, but it is hard to estimate whether eventually they would be net positive or negative.

It is difficult to estimate at this moment how the relations of global economies will evolve in this area and what their potential effects will be. At their end-July meeting the presidents of the European Commission and the USA calmed the tensions down and reached an agreement on cooperation in trade. In mid-October the USA announced they would open trade negotiations with the EU in the coming period. What matters is that Serbian exports are highly product-diversified and geographically-dispersed and that Serbia is building its export supply and targeting other markets too – not only that of the EU. By doing so, Serbia is becoming more resilient to any shocks that may arise on this account.

[6] "Opportunities and Threats for EU Firms in the US-China Trade War", Economic and Financial Analysis, ING, October 2018.

V Inflation projection

Under the November central projection, which is almost unchanged from August, y-o-y inflation will continue to move within the target tolerance band in the next two years – below the target midpoint until end-2019, trending temporarily closer to the midpoint in the first months of that year due to the low base effect.

As regards inflation factors, in the short run disinflationary pressures will stem from the low food production costs and in the course of 2019 also from the high base effect of fruit, vegetable and petroleum product prices. Working in the opposite direction will be the assumed 4% growth in administered prices. Disinflationary pressures generated by the past appreciation of the dinar will gradually wane in the coming period, while aggregate demand will be the main factor shaping the inflation outcome in the medium term.

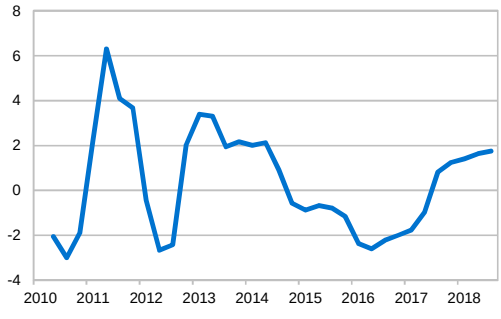
GDP growth projection for 2018 has once again been revised up, to around 4.2%, in view of the faster than expected growth in construction and agriculture since the beginning of the year – on the production side, and investment – on the expenditure side, which were highlighted as upside risks in the August projection. GDP growth projection for 2019 has been kept unchanged at 3.5%, having in mind, among other factors, this year's high base. Looking ahead, GDP growth will continue to be led dominantly by domestic demand, though further dynamic export growth will also play a role. We expect that persistent growth in aggregate demand will have a positive impact on the services sector and that accelerated exports will catalyse manufacturing. On the production side, these two are expected to be the main drivers of GDP growth going forward.

The medium-term inflation projection aims to show expected inflation movements (CPI) in the coming period, the main factors behind such movements and the underlying risks. The projection is set out in the form of a range and the central projection. 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

The macroeconomic conditions in which monetary policy was implemented remained favourable in Q3, as evidenced by the movement in key macroeconomic indicators. Consistent with our expectations, inflation continued to move within the target band, measuring in September 2.1% y-o-y. At the same time, more than a half of inflation growth is attributable to two groups of prices only – prices of petroleum products and fruits and vegetables, which suggests that the underlying inflationary pressures have stayed low. The contribution of petroleum product prices was higher than at end-Q2, as these prices continued up, mirroring the movement in oil prices in international markets. After marking unexpected gains from April onwards, fruit and vegetable prices, the most volatile inflation component, decreased in Q3 more

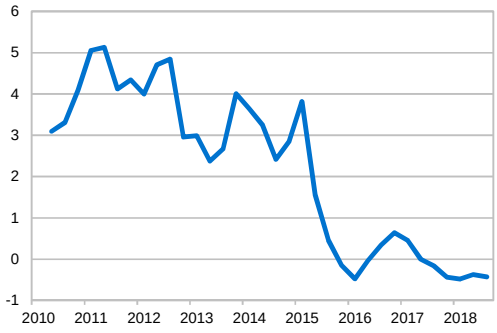
Chart V.0.1 **Monetary Conditions Index***
(in %)



Source: NBS.

* The monetary conditions index is a combined indicator of the gap of the real interest rate and the gap of the real exchange rate. Value >0 indicates restrictive monetary conditions, and value <0 indicates expansionary monetary conditions.

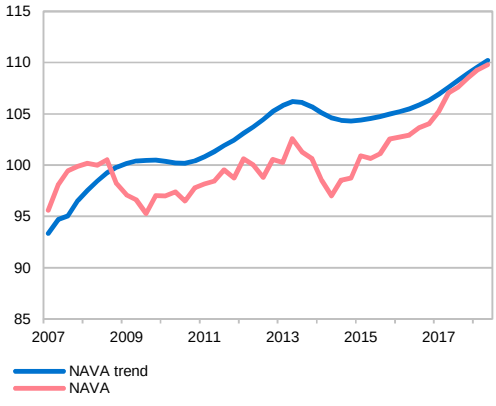
Chart V.0.2 **Real interest rate**
(in %)



Source: NBS.

Note: 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.

Chart V.0.3 **Output gap**
(Q3 2008 = 100)



Sources: SORS and NBS calculation.

than usual for that period of the year, adding less to inflation than at the end of Q2. Low inflationary pressures are further confirmed by core inflation, which remained stable and low at around 1% y-o-y. That inflationary pressures are subdued is also indicated by both one- and two-year ahead inflation expectations of the financial and corporate sectors, anchored around the target midpoint of 3% for quite some time already.

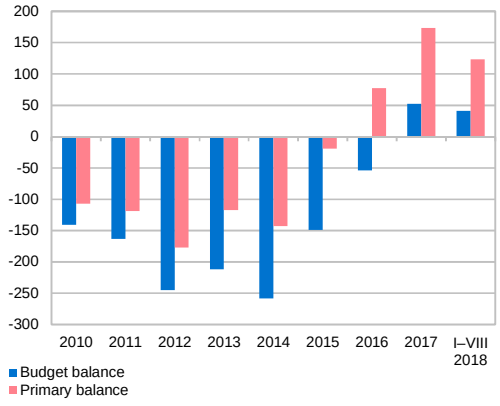
Appreciation pressures in the domestic FX market prevailed for the major part of Q3, reflecting persistently vibrant exports and a high FDI inflow. They weakened in September and October, turning on some days into milder depreciation pressures. In terms of factors in the domestic FX market, appreciation pressures were underpinned by the high net purchases of foreign cash and increased payment card payments by non-residents in Serbia (typical for the summer months due to FX inflow from tourism), and rising FX-indexed lending to the corporate sector. These inflows significantly exceeded the FX demand of local enterprises and non-residents in July and August, while in September and October FX demand and supply were almost balanced. End-of-period, in Q3 the dinar lost 0.3% against the euro and as much against the dollar, because the value of the euro against the dollar remained broadly unchanged.

Since April this year the key policy rate has been kept on hold at 3.0%, i.e. its lowest level in the inflation targeting regime. The Monetary Conditions Index, showing a combined impact of the real interest rate gap and the real exchange rate gap, continued to move above the neutral level in Q3, on account of the real appreciation of the dinar. The real interest rate, on the other hand, stayed below the neutral level, indicating the same degree of monetary policy accommodation on that account as in Q2.

Economic activity is estimated to have moved close to its potential in Q3. Even though external demand slackened, notably from the euro area, reflecting negatively on manufacturing production in recent months, it was domestic factors that provided a strong push to economic growth. Thus, economic growth in H1 outperformed even the expectations stated in the previous *Report* (4.9% y-o-y) and continued at a brisk pace in Q3 as well. Economic growth is estimated to have reached 3.7% y-o-y in Q3, led by services, agriculture and construction, while receiving headwinds from industry, mainly due to the overhaul in the energy sector and low rivers, which caused a downturn in the sectors of mining and energy.

In the face of a significant increase in government capital expenditure, consolidated budget continued to record a surplus, which in the year to August amounted to RSD 41 bn. Excluding interest expenses, the primary surplus equalled RSD 123 bn. In the first eight months of the year, consolidated revenues rose in real terms by 3.4% y-o-y, as a result of higher social insurance contributions and income tax amid formal labour market recovery, as well as of higher non-tax and excise tax revenues. At the same time, consolidated expenditure climbed by 6.9% y-o-y in real terms, due to significantly higher capital expenditure, and to a certain extent, outlays for the purchase of goods and services, as well as employee expenses, while expenses on account of interest payments, budget loans and called guarantees declined. At end-September, central government public debt equalled EUR 23.9 bn and its share in projected GDP was 55.9% (compared to 57.9% at end-2017). Owing to the government's decision to borrow more in the domestic market by issuing long-term dinar securities and thus reduce the currency risk and contribute to public debt sustainability, the share of dinar debt increased from 23.0% at end-2017 to 25.9% in September 2018.

Chart V.0.4 **General government fiscal and primary budget balance**
(in RSD bn)



Source: Ministry of Finance.

Inflation projection assumptions

External assumptions

Economic indicators point to stable global economic growth, though probably somewhat slower than expected initially. After robust growth in 2017, global trade – one of the main indicators – shed some of its momentum this year. Though the latest available data point to a pick-up in trade in July, this pick-up is assessed to be temporary, given the decrease in global new export orders in September.[23] Most of the relevant institutions scaled down their global growth forecasts, which explains why the growth forecast for this and the next year is practically unchanged from the actual figure recorded in 2017. Thus, the IMF revised in October its growth projection for both 2018 and 2019 to 3.7%, down by 0.2 pp from July, explaining that the balance of risks has shifted to the downside in a context of elevated policy uncertainty. Concerns are associated primarily with growing protectionism in external trade, a potential reversal of capital flows to emerging market economies with weaker fundamentals and heightened geopolitical tensions. The IMF also underscores that growth in advanced economies will be above potential in the coming period, but that it will slow in the medium run,

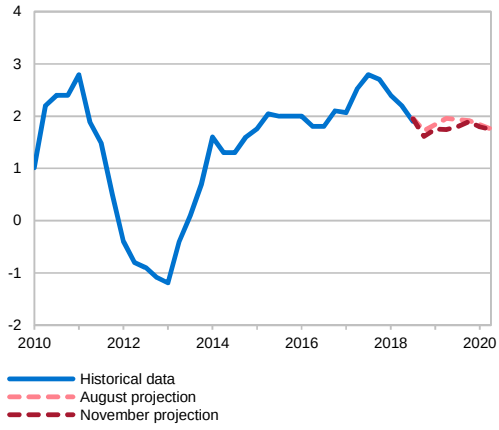
Table V.0.1 **Major projection assumptions**

	2018		2019		2020	
External assumptions	Aug.	Nov.	Aug.	Nov.	Aug.	Nov.
Euro area GDP growth	2.1%	2.0%	1.9%	1.8%	1.7%	1.7%
Euro area inflation (annual average)	1.7%	1.7%	1.7%	1.7%	1.7%	1.7%
3M EURIBOR	0.0%	0.0%	0.14%	0.11%	0.53%	0.48%
International prices of primary agricult. commodities (Q4 to Q4)*	11.3%	6.0%	6.0%	9.0%	4.0%	5.0%
Brent oil price per barrel (year-end, USD)	74	77	71	75	68	72
Internal assumptions						
Administered prices (Dec. to Dec.)	4.0%	2.6%	4.0%	4.0%	4.0%	4.0%
Trends						
Appreciation trend of the real exchange rate (average)	0.5%	0.3%	0.6%	0.4%	0.6%	0.5%
Real interest rate trend (average)	0.4%	0.5%	0.3%	0.4%	0.2%	0.3%

* ECB Survey of Professional Forecasters.
** Composite index of soybean, wheat and corn prices.
Sources: NBS, ECB, CBOT and Bloomberg.

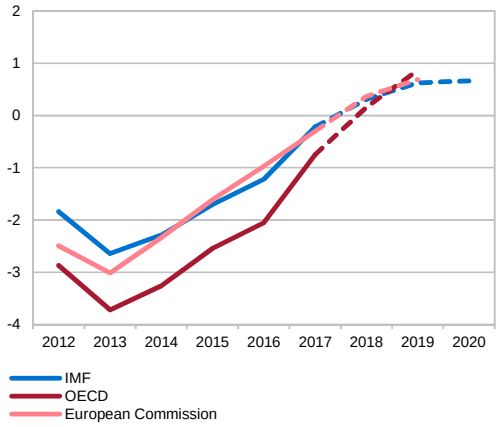
[23] Global Monthly, World Bank, October 2018.

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



Source: ECB.

Chart V.0.6 **Assumption for euro area output gap**
(% of potential GDP)



Sources: IMF, OECD and European Commission.

while emerging economies as a group are set for stable growth even in the medium run, with some differences across regions.

The forecast **economic growth of the euro area, our key trade partner**, has been trimmed down slightly for both this and the next year, though it is expected to stay above potential. Consistent with the latest available ECB projection (September 2018), we have cut the euro area growth projection for 2018 and 2019 by 0.1 pp, to 2.0% and 1.8% respectively, while keeping the projection for 2020 unchanged from August at 1.7%. The ECB underscored in October that incoming information, though somewhat weaker than expected, remains overall consistent with the baseline scenario of an ongoing broad-based economic expansion, supported by domestic demand and continued improvements in the labour market. The ECB also stressed that the monetary policy measures will continue to underpin domestic demand and that private consumption is fostered by ongoing employment growth and rising wages. At the same time, business investment is supported by solid domestic demand, favourable financing conditions and corporate profitability. In addition, the expansion in global activity is expected to continue supporting euro area exports, though at a slower pace. As in the previously released projections, the ECB expects growth to soften in 2019 and 2020 amid a waning impact of past monetary easing and the effect of supply-side factors, such as high levels of capacity utilisation and a lack of labour force in some member states. The ECB judges that the risks surrounding the euro area growth outlook are still broadly balanced, though risks relating to protectionism, vulnerabilities in emerging markets and financial market volatility remain prominent. With the euro area economy growing at a lower rate than initially expected, in October both the IMF and Consensus Forecast cut their projections for 2018, to 2.0%, down by 0.2 pp relative to July. The projections for 2019 remained unchanged: the IMF places growth at 1.9% and Consensus Forecast, just like the ECB, at 1.8%.

As regards **our key trade partners within the euro area**, Consensus Forecast trimmed Germany's growth projection for this year by 0.1 pp, to 1.9%, while keeping the one for 2019 at 1.7%. In 2020 the German economy is envisaged to grow 1.6%. A considerable risk to the export-oriented German economy stems from the possible escalation of trade tensions, and particularly from the US hint at introducing tariffs on imported cars and car parts. Consensus Forecast also trimmed down the

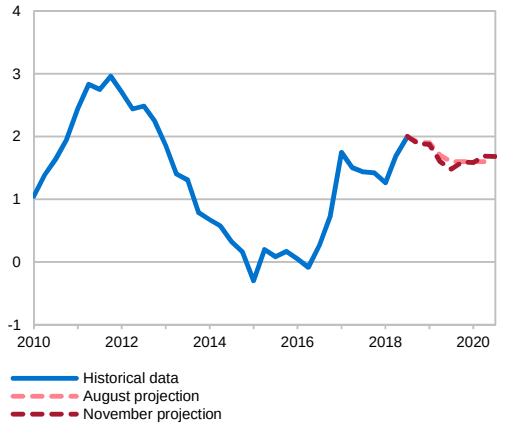
projections of Italy's growth for this and the next year, by 0.1 pp each, to 1.1% and 1.0%, while the projected growth for 2020 equals 0.9%.

While the projections of global and euro area growth have been revised down, those for the **majority of countries in the region**, which are also Serbia's important trade partners, have not. The reason lies in the recovery of domestic demand that counterbalances the effects from the international environment. According to the October Consensus Forecast, the region of South East Europe is expected to grow 3.5% in 2018 and 3.3% in 2019, which is by 0.1 pp less than envisaged in July, due mainly to the deceleration of Romania's growth after exceptionally high growth rates recorded in 2017. As before, growth in the majority of other countries is expected to accelerate, with investment and private consumption remaining its main drivers. The forecast of Serbia's growth for this year has been significantly upgraded, from 3.4% to 4.1%, and for 2019 from 3.2% to 3.4%.

Economic growth has still not caused any major inflationary pressures in advanced and emerging economies. In September the ECB kept its inflation projection unchanged from June – namely the ECB expects inflation to be slightly below the target, at 1.7%, in all years over the projection horizon (2018–2020). The projected trajectory of stable annual inflation rates reflects a gradual rise in core inflation, which will be moderated by the forecast drop in energy prices due to the high base effect, and, according to the current price of oil futures, the expected mild decline in oil prices. The gradual rise in core inflation, from 1.1% in 2018 to 1.8% in 2020, is expected primarily because of the improved cyclical position of the economy, and, by extension, acceleration of wage growth. Just like the ECB, professional forecasters[24] expect inflation to be stable over the projection horizon, at the level of 1.7% in all three years, and have not changed their expectations relative to July. Long-term market expectations also remained stable in the last three months, at 1.67%.[25] Consistent with the ECB's forecast, our new projection assumes stable inflation in the euro area at 1.7% in the period 2018–2020.

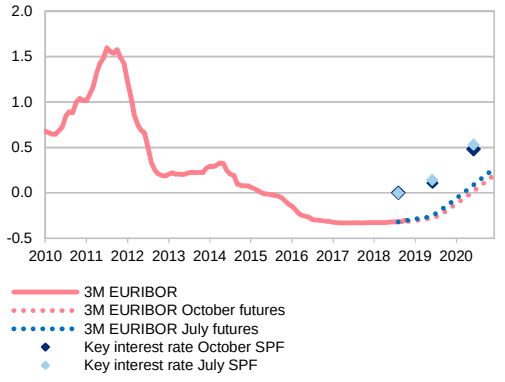
Major inflationary pressures are not expected in the countries of the region either. Consensus Forecast kept its inflation projection for South East Europe at 3.4%, i.e. unchanged from July, while revising the projection for 2019 slightly up (from 2.9% to 3.0%).

Chart V.0.7 **Assumption for euro area inflation**
(y-o-y growth, in %)



Source: ECB.

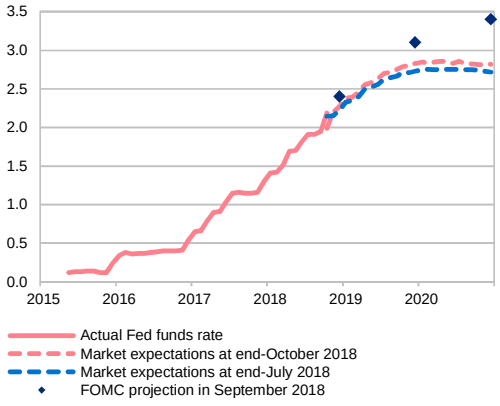
Chart V.0.8 **Expected ECB interest rate* and 3M EURIBOR futures**
(p.a., in %)



Sources: ECB and Bloomberg.
* ECB Survey of Professional Forecasters (SPF).

[24] ECB Survey of Professional Forecasters (SPF).
[25] The five-year, five-year breakeven forward.

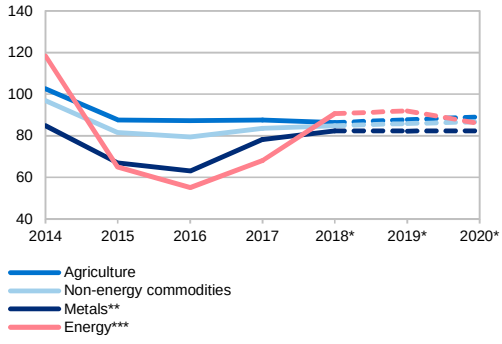
Chart V.0.9 **Expected Fed funds rate***
(p.a., in %)



Sources: Fed and Bloomberg.
* Futures-based market expectations.

Conditions in the international financial market remain favourable. The **ECB** scaled down its monthly net asset purchases to EUR 15 bn (from EUR 30 bn) as of October and confirmed that the programme would end by the end of the year. After the programme is ended, the ECB will continue to reinvest the principal payments from maturing securities, i.e. it will not reduce its balance sheet "for an extended period of time". The "extended period of time" is assessed by analysts to last from two to three years. The ECB also confirmed the announcements made in June – that it would keep its key interest rates unchanged at least through the summer of 2019. Based on the ECB's October survey, professional forecasters expect the policy rate to stay zero for some time to come, and to rise steadily in 2019 and 2020, though at a slower pace than expected three months ago. A slightly slower pace of normalisation of the ECB's monetary policy is also suggested by the end-October EURIBOR futures, according to which three-month EURIBOR should remain negative all the way until mid-2020 (not until the start of 2020, as expected at end-July).

Chart V.0.10 **Projection of movement in primary commodity prices**
(2010 = 100)

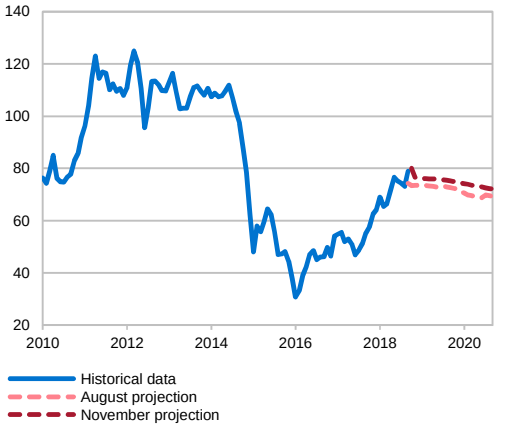


Source: World Bank.
* World Bank projection, October 2018
** Base metals and iron ore.
*** Crude oil, natural gas and coal.

On the other hand, global financial conditions, capital flows to emerging economies, relationships between major currency pairs, and commodity markets will also be affected by the further normalisation of the Fed's monetary policy. Consistent with expectations, the **Fed** increased its target range for the federal funds rate in September, for the third time since the start of the year, to 2.0–2.25%. It also continued to reduce its balance sheet as planned, while lowering as of October the reinvestment of the principal by USD 50 bn a month (previously USD 40 bn a month). The Fed is expected to proceed with monetary policy normalisation in the period ahead, in line with rising economic activity and inflation, as well as favourable labour market trends. The Fed's September projections suggest another rate hike in December, just as they did in June, though the number of the FOMC members expecting the hike is now higher. Based on the Fed's projections, another three hikes can be expected next year, and one hike in 2020. As a result, the Fed's key rate would reach around 3.4%, and would most likely stay at that level in 2021. As regards market participants, they continue to expect a slower pace of rate hikes than suggested by the Fed's projection, which might give rise to instability in the international financial markets in the period ahead.

Uncertainty in terms of future trends in the international environment relates to movements in **global primary commodity prices**. This primarily concerns the global oil price, on an upward path for more than a year. Shooting past USD 80 per barrel, the oil price increased by 5.5% in Q3, driven by the supply-side factors. In the course of October the market calmed down and the price receded as a result of increased output of Saudi Arabia. In the coming period too, the global oil price will be largely determined by the supply-side factors. Downward pressure is likely to come from higher US production estimated to top this year the record set in 1970.[26] On the other hand, global economic growth is expected to stay relatively strong, despite differences across regions, which will fuel the demand for oil. In accordance with oil futures from early November (average for the last two weeks), the new projection operates on the assumption that the global oil price will stand at USD 77 per barrel by the end of the year, whereafter it will gradually decline – first to USD 75 by end-2019 and then to USD 72 per barrel by end-2020. The oil price fall in 2019–2020 will probably be mostly driven by the rising shale oil extraction in the USA.

Chart V.0.11 **Assumption for Brent oil prices**
(USD/barrel)



Source: Bloomberg.

Looking at other primary commodities, the global **metals** market experienced high volatility, mainly on account of protectionist measures, US sanctions on the Russian aluminium producer and rising trade policy uncertainty. According to the World Bank,[27] metals prices were 10% lower in Q3 than in Q2. It is difficult to estimate the outlook for metals prices, considering their acute sensitivity to global trade tensions, demand from China (which accounts for more than a half of global metal consumption) and the exchange rate of the dollar. The World Bank expects metals prices to stabilise in the coming period. As estimated by the IMF, metals prices in 2018 will be 5.3% higher than last year, whereas in 2019 they will be 3.7% lower than this year's average.[28] Basically, demand and supply conditions in the metals market work towards an increase in prices, which are currently significantly below the maximum of seven years ago. Downside risks emanate from trade tensions, higher metal production in China and the slackening of the Chinese economy.

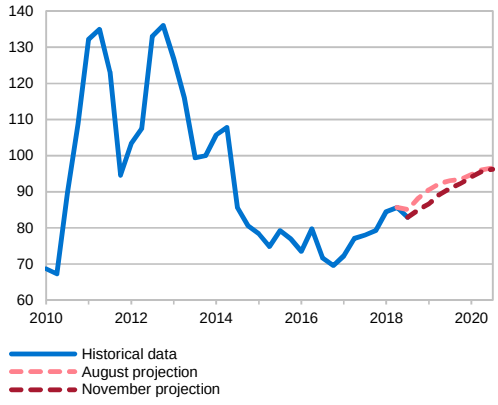
As in the case of metals, global prices of **primary agricultural commodities** recorded a decline since our

[26] Bloomberg Opinion, 23 October 2018.

[27] Commodity Markets Outlook, World Bank, October 2018.

[28] World Economic Outlook, October 2018.

Chart V.0.12 **Assumption for international prices of primary agricultural commodities**
(Q4 2013 = 100)



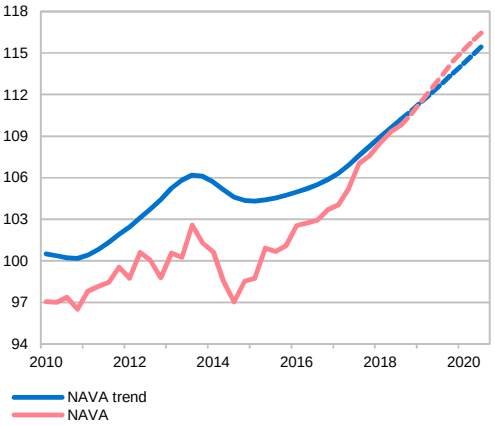
Sources: CBOT and NBS calculation.

previous projection, but the situation here is nevertheless more stable, even though tariffs were imposed on some key agricultural products. According to the World Bank,[29] agricultural prices fell by 7% in Q3 relative to Q2. A range of factors contributed to the weakness, such as ample supplies for most grains (except wheat), protectionist measures (which affected soybean the most), and emerging market currency depreciations (especially the Brazilian real). Based on the IGC October report,[30] total world grain production is expected to decline by 1% y-o-y in 2018/19 to a three-year low. A better corn harvest, notably in the USA, is seen being outweighed by falls for other crops, especially wheat and barley. At the same time, demand is poised for limited growth, wherefore price growth should be moderate too. A moderate rise in agricultural prices is also expected by the IMF, which cites weather conditions as the greatest upside risk to the price forecast. The key downside risks to agricultural prices, according to the IMF, stem from the deepening conflict between the USA, the world's largest food exporter, and their main trade partners.[31] Based on futures on the Chicago mercantile exchange, this time again our assumption of agricultural commodity price growth in 2018 has been lowered relative to the previous medium-term projection (to 7.2% from 11.3%), chiefly in response to the fall in global agricultural prices in the period since August. As regards 2019, the projection assumes somewhat higher growth (9.0% instead of 6%) given that these prices are expected to return from the currently relatively low levels to a neutral level.

Internal assumptions

Primary agricultural commodity prices in the domestic market recorded a fall since our previous projection, causing a decline in food production costs. These prices were mainly under the influence of global commodity markets, which reacted to global assessments of new grain yields and trade tensions. Besides, high yields and logistics-related export issues, due to low rivers, also contributed to the fall. Based on our composite index, primary agricultural commodity prices in the domestic market declined by 9.3% in Q3. The sharpest decline was registered for corn and soybean, while wheat marked gains. The October composite index suggests that primary agricultural commodity prices went up by 2.6%. Consistent with these movements, food production costs in Q3 again drifted below the neutral level. In the coming period, as so far, domestic

Chart V.0.13 **Output gap projection**
(Q3 2008 = 100)



Sources: SORS and NBS calculation.

[29] Commodity Markets Outlook, World Bank, October 2018.
[30] Grain Market Report, International Grains Council, October 2018.
[31] World Economic Outlook, October 2018.

agricultural commodity prices are likely to mirror the dynamics of their global counterparts to a large degree. After growing this year less than envisaged in the previous projection, we expect these prices to rise moderately in both 2019 and 2020. In line with these movements, food production costs are assumed to stay below the neutral level probably by mid-2019.

Economic activity is estimated to have continued moving close to its potential in Q3. The **output gap**, negative since 2008 as a consequence of the spillover of the global financial crisis to Serbia, will most probably close by end-2018. Still, it has displayed a closing tendency for more than two years already owing to labour market improvements, past monetary policy easing by the NBS and rising external demand. Until the end of the projection horizon, i.e. in Q3 2020, the output gap is likely to reach around 1.0%. We expect that demand will rise on account of the continued **positive labour market** trends, notably further growth in wages and employment.

At end-Q3, y-o-y a**dministered price** growth stabilised at a relatively modest last year's level of 2.9%. However, as there was no increase in electricity and natural gas prices this year, administered price growth should fall in October to 2.4% y-o-y and stay close to that level until the end of the year. This means that total administered price growth in 2018 will be lower than envisaged in our August projection (4.0%). The assumptions for their growth in 2019 and 2020 were kept at around 4.0%.

The projection operates on the assumption that **inflation expectations** will remain anchored around the target midpoint until the end of the projection horizon.

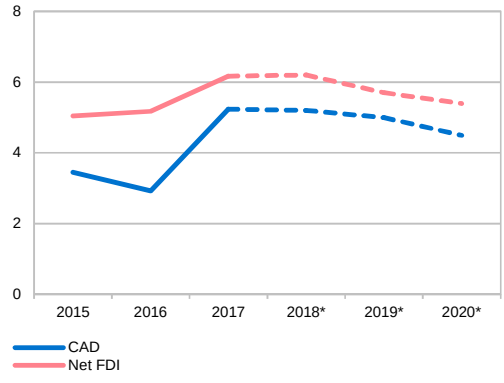
Even though the Fiscal Strategy envisages a general government deficit of 0.7% of GDP in 2018, hitherto trends **clearly point to a surplus**. It is important to note that even with the planned deficit of 0.7% of GDP in 2018, i.e. 0.5% of GDP in the medium term, the Strategy envisages a continued downward trajectory of the share of public debt in GDP going forward. Given the December maturing of securities issued in the international market in 2013 (USD 1 bn), we expect a further contraction in public debt and its share in GDP on that account by the end of the year (by around 2 pp). Furthermore, before the year ends the government plans to repurchase three-year dinar securities before maturity, in the amount of RSD 20 bn, which will provide an additional contribution to the reduction in the share of public debt in GDP, and thus, to Serbia's greater resilience to shocks from the international environment.

Table V.0.2 **Fiscal Strategy 2018−2020**
(in % of GDP)

	2018	2019	2020
Public revenues	42.4	41.8	41.1
Tax revenues	37.3	37.0	36.6
Non-tax revenues	4.7	4.5	4.2
Public expenditures	43.1	42.3	41.6
Expenditures for employees	9.8	9.7	9.6
Pensions	11.1	11.0	11.0
Interests	2.5	2.3	2.1
Capital expenditures	3.6	3.7	3.7
Total balance	-0.7	-0.5	-0.5
Primary balance	1.9	1.8	1.6

Source: Ministry of Finance.

Chart V.0.14 **Current account deficit and net FDI inflow**
(in % of GDP)



Source: NBS.
* NBS projection.

Exports are expected to maintain a high growth rate in 2018, led by past investment and rising external demand. Imports of equipment and intermediate goods are also expected to rise owing to the continuation of the investment cycle. Taking this into account, the **share of the current account deficit** in GDP this year is estimated to stay at last year's level of 5.2%, and decline gradually thereafter. Given that a stronger impact of the current investment cycle on export growth is expected in the years to come, the share of the current account deficit should gradually contract, to around 4.5% of GDP in 2020. As so far, FDI will be more than sufficient to cover the current account deficit, contributing to relatively stable movements in the FX market in the period ahead.

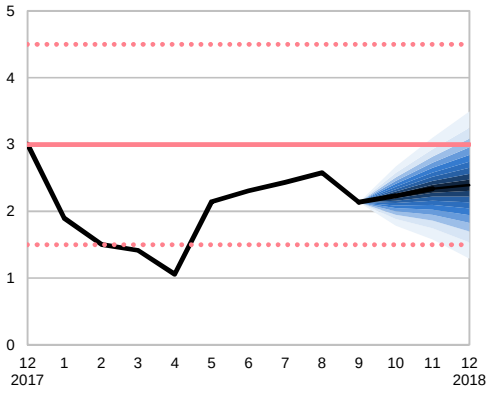
Given the expected maintenance of positive macroeconomic trends in the coming period, domestic factors are likely to have a positive impact on the **country risk premium** until the end of the projection horizon. Standing out among these factors are stronger resilience to external shocks and favourable prospects which are expected to outweigh the potential negative impact of global factors such as heightened trade tensions, reduced global liquidity and rising volatility in financial and commodity markets.

Projection

Inflation projection

Under our current projection, which is almost unchanged relative to the one released in August, y-o-y inflation will stay low and stable in the next two years. It will continue to move within the target tolerance band – until end-2019 most probably below the target midpoint, getting temporarily closer to the midpoint in the first months of 2019 due to the low-base effect.

Chart V.0.15 **Short-term inflation projection**
(y-o-y rates, in %)



Source: NBS.

Short-term inflation projection

Y-o-y inflation is expected to remain low and stable in Q4, revolving around the Q3 average. The same applies to core inflation (CPI change excluding the prices of food, energy, alcohol and cigarettes), which should remain stable (around 1.0% y-o-y) in Q4 as well.

In **quarterly terms**, consumer prices are likely to rise slightly in Q4, reflecting somewhat higher fresh vegetable and energy prices. Working in the opposite direction will be lower fruit and fresh meat prices, though this category of prices is estimated to fall less than typical for this time of the year. Administered price growth in Q4 is also judged to be negligible, given that there will probably be no adjustment of electricity and natural gas prices until the end of the year.

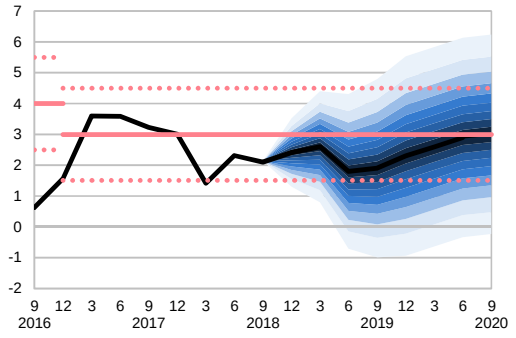
The risks to the short-term inflation projection are associated primarily with the prices of unprocessed food, most notably fruit and vegetables, and developments in global commodity and financial markets and their short-term effects on prices in Serbia.

Medium-term inflation projection

Starting from projection assumptions, we expect y-o-y inflation to continue to move within the target tolerance band in the next two years – most probably below the target midpoint by late 2019, though it will temporarily approach the midpoint in the first months of the next year due to the low base effect.

A relatively stable inflation path until the end of the projection horizon, i.e. over the next two years, reflects the workings of different factors, some of which will influence inflation throughout the period observed and some in the short term only. Same as in the previous projection, the factor expected to play the key role throughout the projection period, i.e. in the medium-term, is growth in aggregate demand. The disinflationary pressures on account of past appreciation of the dinar will gradually wane, and administered price growth will pick up slightly next year. In the short term, disinflationary effects will stem from the low food production costs, and in the coming year also from the high base for fruit and vegetable and petroleum product prices, whose contribution to inflation will be declining.

Chart V.0.16 **Inflation projection**
(y-o-y, in %)

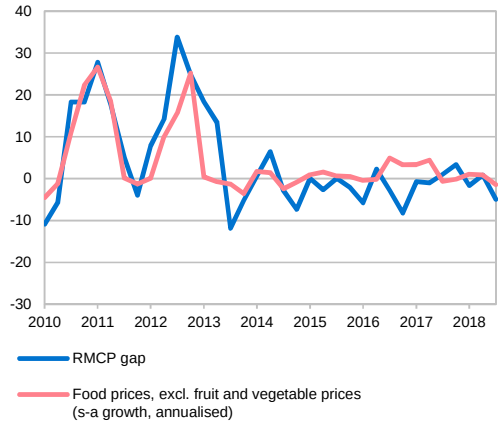


Source: NBS.
The fan chart depicts probability of various inflation outcomes in the next eight quarters. Central projection is within the darkest central band and the probability that inflation would lie in it is 10%. Each following shade includes 10% probability, which means that outturns of inflation 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%.

The rise in **aggregate demand**, almost uninterrupted since end-2014, is likely to continue, i.e. disinflationary pressures on account of the negative output gap will grow weaker and, according to our estimate, dissipate by the end of this year. As of 2019, the output gap is expected to move in the positive territory. Such movement will be supported by the positive labour market trends and rising public sector wages and pensions, through the positive influence on the disposable income of households. Disposable household income also benefits from lower interest rates and, consequently, lower loan repayment expenses, which were achieved thanks to the past monetary policy easing of the NBS. Serbia's economic activity will receive a positive impetus from euro area economic growth, albeit slower than in previous projections, ECB's monetary policy, which remains highly accommodative, and persistently low interest rates on euro-indexed loans.

Past appreciation of the dinar exerted a disinflationary effect through lower import prices expressed in dinars. In this regard, we expect disinflationary pressures to persist for some time yet, though they will gradually wane. Still,

Chart V.0.17 **RMCP and food prices**
(in %)



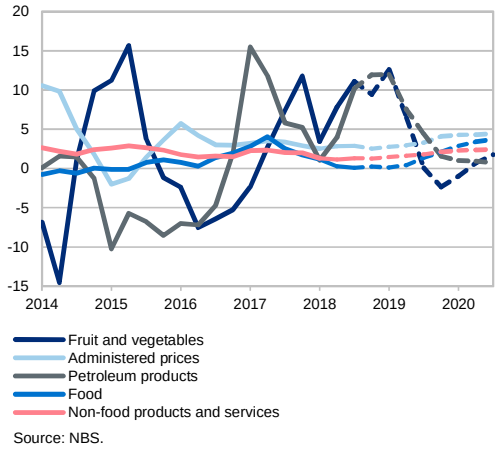
Sources: Novi Sad Mercantile Exchange, SORS and NBS calculation.

given that the dinar exchange rate is expected to be relatively stable and the rise in prices in the euro area, our main trading partner, to remain stable at 1.7%, growth in import prices denominated in dinars is likely to stay relatively low until the end of the projection horizon.

The costs of raw materials in food production are estimated to be below their neutral level. Namely, since the last medium-term projection, the prices of primary agricultural commodities declined both in Serbia and at the global level, which caused a decline in food production costs. As the prices of primary agricultural commodities are expected to rise moderately in the next two years, food production costs should stay below the neutral level until mid-next year. After that, these costs are expected to rise above the neutral level, consistent with the expected growth of primary commodity prices in the global market, since they are the major factors behind the movement of the prices of these products in the domestic market.

As for **administered prices**, their growth in the year to date stabilised at a relatively low last-year's level (2.9%). Given that the expected increases in electricity and natural gas prices did not take place this year, administered price growth should fall to 2.4% y-o-y in October and remain close to that level until year-end. Such price growth will be lower than assumed in our August projection (4.0%), so the contribution of these prices to inflation is likely to be lower than we expected (0.1 pp instead of 0.2 pp). Administered price growth next year is projected at around 4%, which makes their contribution to the projected inflation 0.3 pp higher.

Chart V.0.18 **Projection of inflation components**
(average y-o-y rate, in %)



Source: NBS.

As expected in August, the main disinflationary impact in the coming year will stem from the high base for fruit and vegetables and petroleum product prices. **Fruit and vegetable prices** rose in the past months and continued to move above the neutral level. Therefore, in the coming period their contribution to inflation is likely to dwindle, entering perhaps the negative territory next year. Due to the rise in the **global oil price** in the prior period, petroleum products grew more expensive and their contribution to headline inflation edged up to 0.6 pp in September. If the oil price stabilises in line with the projection assumptions, the contribution of petroleum products to inflation should edge up to 0.7 pp by the end of this year (0.5 pp under the August projection), and gradually decrease thereafter, coming close to zero by end-2019, as this year's price hike drops out from the y-o-y calculation.

Speaking of other inflation components, the y-o-y growth in **food prices** (excluding fruits and vegetables) is expected to trend relatively low at least by mid-next year, since low costs of raw materials in food production will continue to exert disinflationary pressure for some time yet, contrary to the impact of the rising domestic demand and weakening disinflationary pressures on account of the past appreciation of the dinar. The impact of past appreciation is reflected in relatively low **non-food inflation**, measuring around 1.2%. Same as in the previous projection, in the coming period food inflation is expected to pick up moderately on the back of rising aggregate demand and steady dissipation of the effects of past appreciation of the dinar, but should remain below 3% until the end of the projection horizon.

Uncertainty surrounding the inflation projection relates primarily to movements in the international commodity and financial markets and, to some extent, administered price growth at home.

Primary commodity prices in the **international market** could turn out to be lower than assumed, due to both demand and supply side factors. The risks to the projection stemming from the movements of primary commodity prices in the global market are therefore judged to be symmetric.

Looking at demand side factors, as the downside risks to global economic growth prevail, it appears more likely that the demand for primary commodities will underperform as well. The deepening of trade tensions could dent business optimism and reflect negatively on investment, world trade and economic growth, reducing the demand for primary commodities, notably **oil**. Nevertheless, the World Bank assesses that the negative impact of protectionist measures on primary commodity prices would probably be more pronounced in the short than in the medium term. It would turn out moderate in the medium term, because producers/consumers would find new export/import markets.[32] The demand for primary commodities would be affected most severely by the slowing of China's growth, given that the market of these commodities has changed significantly over the last 20 years and that China's economy has become the main driver of demand for primary commodities in the global market, mainly demand for coal and metals. On the other hand, trade tensions might calm down, in which case the negative effects on global growth and demand for primary commodities would not materialise.

Speaking of supply side factors, it should be noted that they are specific for each primary commodity. Uncertainty in the oil market arises from geopolitical tensions, primarily the impact of US sanctions on Iran's oil exports, a potential further deterioration of Venezuela's production and inability or unreadiness of other OPEC countries to ramp up their oil production substantially. Conversely, a greater than expected hike in OPEC and US oil production could push down the global oil price. The World Bank estimates that oil prices will probably trend upward in H1 2019, but that their trajectory will reverse thereafter, with the removal of bottlenecks in US production. Potential growth in global oil prices would also reflect on the prices of **primary agricultural commodities**, mainly grains, not only through the rising costs of fuel and fertilisers in agricultural production, but also through incentives to the production of biofuel. On the other hand, the tightening of trade tensions could trigger a further fall in the prices of primary agricultural commodities. It should also be kept in mind that in the last few years the prices of primary commodities in the global market picked up slightly or even declined, despite the fact that futures indicated their growth.

The risks to the projected inflation path are also associated with the movements in the **international financial market**, primarily the character of the Fed's and ECB's monetary policies and, consequently, conditions in the international financial market and the relationship between the euro and the dollar. Greater uncertainty surrounding the growth and inflation outlook also fuels uncertainty regarding the pace of normalisation of monetary policies of leading central banks. Concerns are mounting in the euro area as to the repercussions of the dispute about Italy's budget deficit and public debt, the introduced and announced protectionist measures of the US, and Brexit. On the other hand, the US economy is operating above full employment level and the path of the federal funds rate expected by the market is lower than the one projected by the Fed. Although the conditions in the international financial market are still favourable, chances are increasing that they might tighten faster than expected by the market. A higher than expected inflation in the US could trigger a hike in interest rates and prompt investors to reassess their investment risk, which might in turn affect global capital flows, primarily portfolio investment toward emerging economies, including Serbia. The tightening of trade tensions and further spread of protectionism in international trade could heighten

[32] Commodity Markets Outlook, World Bank, October 2018.

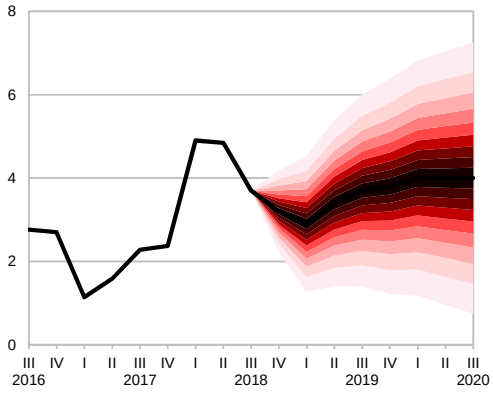
instability in the international financial market and, consequently, fuel uncertainty regarding capital flows. Bearing all these factors in mind, we judge that the risks to the projection on these grounds are mildly skewed to the upside.

The projection is conditioned on the assumption that the growth of **administered prices** this year will drop to 2.6%, after a relatively modest last year's growth of 2.9%. In 2019 and 2020 we assumed administered price growth of around 4%. However, as administered price growth fell short of the projected level in the previous two years, the risks to the projection in this regard are judged to be mildly tilted 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 assessment of the impact of inflation factors from the domestic and international environment. As the key risks emanate from the international environment, the NBS will continue to closely monitor and analyse movements in the international financial market and the market of primary commodities, notably crude oil and primary agricultural commodities, and will assess their impact on economic developments in Serbia. As so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium term which, together with maintaining financial stability, will contribute to sustainable economic growth and strengthen the country's resilience to external uncertainties.

Chart V.0.19 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

GDP projection

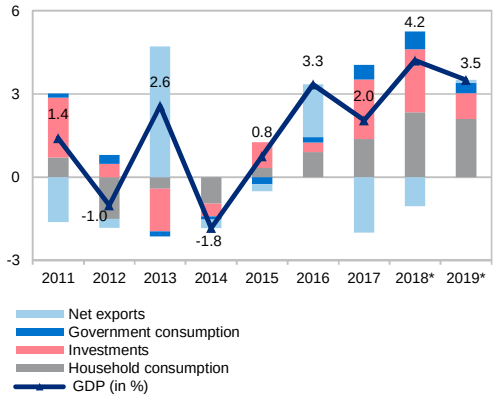
Successful delivery of macroeconomic stability and the improved business environment in the first three quarters of 2018 have enabled Serbia to record the fastest economic growth in ten years (4.5%). Owing to this, as well as to excellent construction and agricultural performance since the beginning of the year which exceeded our expectations, we have revised the GDP growth projection for 2018 again, to 4.2%, i.e. by 0.2 pp relative to August. In addition to agriculture and construction, a positive contribution to GDP growth is expected from a pick-up in the service sectors, led by the further recovery of domestic demand. Positive developments continued in industry too, even though manufacturing lost some steam from a year earlier amid a slower pace of euro area growth.

On the expenditure side, stronger growth than previously expected should be recorded by fixed investment as a result of a significant step-up in infrastructure investments, favourable financial conditions and persistently high FDI inflow. A powerful impetus to GDP growth will continue to come from household consumption underpinned by higher disposable income stemming from the further labour market recovery and stronger consumer confidence in line with the announced increase in pensions and public sector wages and the minimum cost of labour. GDP growth in 2018 will also be supported by exports, as a result of persistently vibrant manufacturing exports and high export supplies of agricultural products following an excellent agricultural season. Still, the contribution of net exports is likely to stay negative in 2018, due to the faster import growth, notably import of equipment and intermediate goods, and to a certain extent, import of consumer goods.

Domestic demand should remain the principal driver of GDP growth in 2019. According to our estimates, however, growth will slow down to around 3.5% due to the high base effect. Household consumption will continue to benefit from a further rise in disposable income, led by the expected growth in wages and employment in the private sector. Besides, investment growth is expected to proceed, supported by the continued implementation of structural reforms, progress in the EU accession process, intensive investment in infrastructure projects, recovery of the real estate market and robust FDI inflow. The effects of past investments contributing to the integration of domestic enterprises into global value chains, as well as further growth in the euro area and countries in the region and the expected growth in agricultural exports should oil the wheels of robust export growth in 2019. Together with the anticipated slowing of imports, this should result in a modest positive contribution of net exports to GDP.

The positive effect of external demand is expected to extend into 2019, boosting the manufacturing output, which is expected to provide a significant contribution to GDP growth on the production side. Still, the largest contribution should come from the considerable pick-up in the sector of services owing to rising domestic demand. Furthermore, construction is expected to continue expanding, though at a somewhat slower pace than in 2018. On the other hand, the projection assumes that agricultural season will be at the level of a multi-year average, wherefore in 2019, given this year's excellent agricultural season and the consequently high base, agricultural production is expected to record a decline.

Chart V.0.20 **Contributions to real GDP growth**
(in pp)



Sources: SORS and NBS calculation.
* NBS estimate.

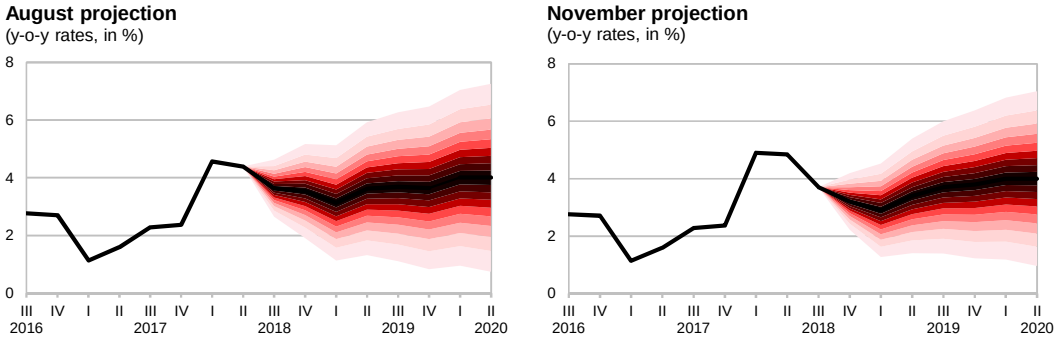
A favourable business environment, which reflects macroeconomic stability and the implemented structural reforms, should create preconditions for medium-term sustainability of the achieved dynamics of economic growth of around 4% a year. At the same time, we expect the GDP growth structure to remain favourable, i.e. led dominantly by investment and exports, and by a viable rise in household consumption.

The risks to the GDP projection are associated primarily with the pace of economic activity in the euro area, developments in the international and financial markets, as well as developments in domestic agricultural production and construction. On balance, the risks to the projection are judged to be symmetric, with those stemming from the international environment tilted slightly to the downside and those from the domestic environment slightly to the upside.

In the last several years Serbia has diversified its exports by products and markets and thus, to a certain degree, reduced its vulnerability to shocks associated with individual segments of external demand. However, as the euro area remains our key trade partner, the slowing of its growth, though assessed as temporary by the European institutions, could spill over to external demand and consequently, dampen Serbia's growth.

The risks to the projection also emanate from prices in the international commodity markets, notably the prices of oil, primary agricultural commodities and base metals. Considering that Serbia is a net importer of oil, a potential rise in its global prices feeding through into lower disposable income of households and higher costs of corporates would to some extent slow down our economic growth. On the other hand, a potential rise in the prices of grains and base metals, where Serbia is a net exporter, would exert a positive impact our exports and GDP.

Chart V.0.21 **Current vs. previous GDP growth projection**



Source: NBS.

Heightened uncertainty in the international market could lead to greater volatility in capital flows to emerging economies and affect relationships between major currency pairs, leading ultimately to higher costs of external financing. However, thanks to macroeconomic stability and reduced internal and external imbalances, Serbia is now much more resilient to any potential shocks on this account. Favourable financial conditions are also underpinned by the ECB's monetary policy. Namely, the ECB announced it would continue to reinvest the principal payments from maturing securities even after the asset purchase programme ends and that it would keep the key rate unchanged at least through the summer of 2019.

One of the projection assumptions is that the agricultural production next year will be at the level of a multi-year average and that it would decline due to the exceptionally good season this year and the consequently high base. Having in mind, however, that agriculture remains largely susceptible to the impact of weather conditions which cannot be predicted with certainty, deviations from the assumption of an average season are equally possible in either direction, resulting in either faster or slower GDP growth.

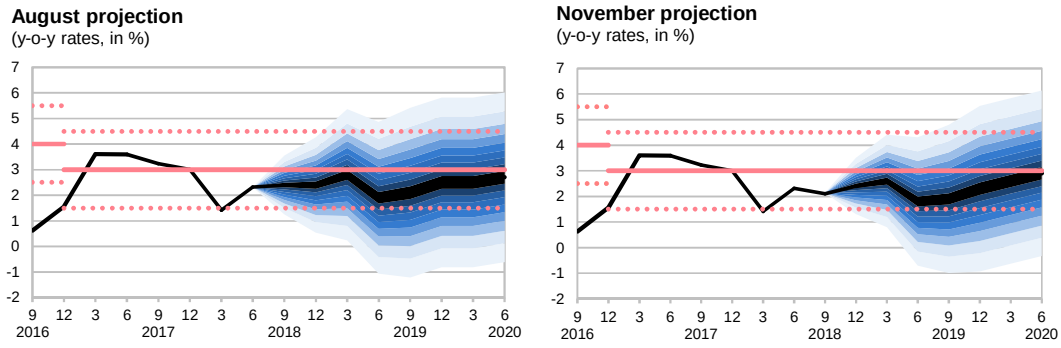
Uncertainty surrounding the GDP projection is also associated with future movements in the construction industry. Our assumption is that construction growth next year will slow down to around 3%, mainly due to the high base effect. At the same time, fiscal savings open up the scope for increased investment in infrastructure projects, which could result in faster construction growth than anticipated. On top of this, the steady recovery of the real estate market could boost activity in housing construction, as signalled by the rising number of issued construction permits and the envisaged value of housing construction works since the beginning of the year. Having this in mind, construction-related risks to the projection are judged to be tilted to the upside.

Comparison and outcome of inflation projections

The new medium-term inflation projection is almost the same as the projection published in the August *Report*. The only differences relate to the contributions of individual inflation components, but as their effects are mutually offsetting, the profile of headline inflation over the projection horizon remains unchanged.

Food prices (excluding fruits and vegetables) should provide a smaller contribution to inflation than envisaged

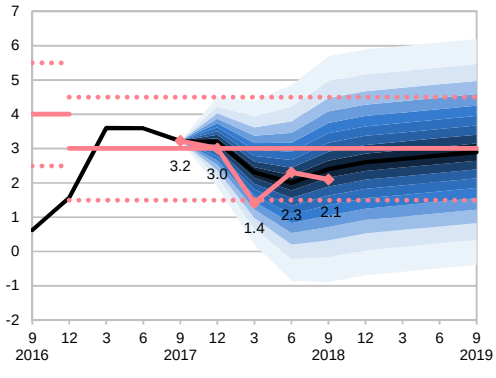
Chart V.0.22 **Current vs. previous inflation projection**



Source: NBS.

earlier. Namely, in the period since the previous medium-term projection primary agricultural commodity prices declined, causing a sharper fall in food production costs, and hence, food prices than we anticipated. Besides, we expect that global primary agricultural commodity prices will decrease somewhat until the end of the projection period, which also makes the level of food prices assumed in the new projection lower than that foreseen by the August projection.

Chart V.0.23 **Achievement of November 2017 inflation projection**
(y-o-y rates, in %)



Source: NBS.

On the other hand, petroleum product prices turned out higher in Q3 than anticipated. Furthermore, their future outturn is also expected to be higher than envisaged by the previous projection.

In the past year, inflation moved within the band projected in November 2017. Most of the time inflation moved around the central projection rate, except in the first months of 2018, when it dipped below that value. The reason for lower inflation outturn in that period lies mainly in lower dinar import prices, lower food production costs and weaker than assumed growth in administered prices. As global oil prices and fruit and vegetable prices trended up since the beginning of the year, inflation returned to the level close to the November 2017 central projection rate and was consistent with our expectations of one year ago.

Projections of other institutions

The period from the previous *Report* is marked by further improvement in projections of the key macroeconomic indicators for Serbia issued by relevant international institutions.

The most significant improvement relates to the upward revision of Serbia's projected GDP growth. The largest upward revision was made by the EBRD (to 4.2% in 2018) and the European Commission and Consensus Forecast (to 4.1%). The IMF and Bloomberg also increased their projections, by 0.5 pp, to 4.0%. Growth projections for 2019 were also raised, most of all by the European Commission, by 0.3 pp, to 3.8%. Other institutions, just like the NBS, expect the Serbian economy to grow by around 3.5% in 2019.

Because of the rise in oil and food prices, international institutions project somewhat higher inflation outcomes, though still below the target midpoint. They expect inflation to trend closer to the target midpoint in 2019, and then to continue revolving around 3.0% midpoint in 2020, which only confirms the confidence international institutions have in the monetary policy implemented by the NBS.

As regards the fiscal result, there is a consensus among international institutions that Serbia will record a surplus this year, ranging from 0.5% to 0.6% of GDP. From 2019 onwards, the IMF envisages that Serbia will record the targeted deficit of 0.5%, while other institutions project an even smaller deficit (0.2–0.3% of GDP). This will ensure a further decrease in the share of public debt in GDP, and thus, greater resilience to external challenges.

Table V.0.3 **Projections of key macroeconomic indicators for Serbia**

	2018		2019		2020	
	Previous	New	Previous	New	Previous	New
Inflation (annual average, in %)						
IMF	1.6	2.1	2.6	2.3	3.0	-
European Commission	1.7	2.1	2.7	2.9	-	3.0
Consensus Forecast	2.1	2.2	2.9	2.9	-	-
Bloomberg survey	2.3	2.2	3.0	2.9	3.2	3.0
GDP (in %)						
IMF	3.5	4.0	3.5	3.5	4.0	-
European Commission	3.3	4.1	3.5	3.8	-	3.8
Consensus Forecast	3.4	4.1	3.2	3.4	-	-
Bloomberg survey	3.5	4.0	3.3	3.5	3.5	3.5
EBRD	2.9	4.2	3.5	3.5	-	-
Fiscal result (GDP, in %)						
IMF	0.6	0.6	-0.5	-0.5	-0.5	-
European Commission	0.6	0.4	0.5	-0.3	-	-0.5
Consensus Forecast	-	-	-	-	-	-
Bloomberg survey	0.0	0.5	-0.3	-0.3	-0.5	-0.5

Sources: IMF (WEO, October 2018; End-of-Mission press release, October 2018; Country Report, July 2018),European Commission (Spring 2018 Economic Forecast and Autumn 2018 Economic Forecast), Consensus Forecast (July and October 2018), Bloomberg Quarterly Survey (July and October 2018) and EBRD (Regional Economic Prospects in the EBRD Regions, May and November).

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Executive Board meetings and changes in the key policy rate

2017

Date	Key policy rate (p.a, in %)	Change (in basis points)
12 January	4.00	0
14 February	4.00	0
14 March	4.00	0
11 April	4.00	0
12 May	4.00	0
8 June	4.00	0
10 July	4.00	0
10 August	4.00	0
7 September	3.75	-25
9 October	3.50	-25
9 November	3.50	0
7 December	3.50	0

2018

Date	Key policy rate (p.a, in %)	Change (in basis points)
11 January	3.50	0
8 February	3.50	0
8 March	3.25	-25
12 April	3.00	-25
10 May	3.00	0
7 June	3.00	0
12 July	3.00	0
9 August	3.00	0
6 September	3.00	0
8 October	3.00	0
8 November	3.00	0
6 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 6 September 2018

At its meeting today, the NBS Executive Board voted to keep the key policy rate at 3.0%.

The Executive Board took into account the expected movement in inflation and its underlying factors going forward, and the effects of past monetary policy easing. After touching this year's low in April, inflation returned within the target band as expected, measuring 2.4% y-o-y in July. The August central projection also indicates that y-o-y inflation will move within the target tolerance band over the next two years – below the target midpoint (3.0±1.5%) until end-2019, temporarily approaching the target in the first months of next year owing to the low base effect. Both the financial and corporate sectors expect that the achieved price stability will be maintained, as signalled by their inflation expectations anchored around the 3% midpoint for both one and two years ahead.

As assessed by the Executive Board, the effects of past monetary policy easing contribute to the acceleration of economic growth, which measured 4.9% y-o-y in the first half of this year, according to the Statistical Office estimate. Such growth exceeds the earlier estimate and is the highest in the past ten years. The Executive Board expects economic growth at around 4% this year, with a high contribution of investment, ensuring further growth in a large number of export-oriented sectors. Investment expansion is supported by favourable financing conditions and credit growth, as well as by the FDI inflow which is more than sufficient to cover the current account deficit, contributing to its reduction in the medium run.

The Executive Board judges that caution in monetary policy conduct is still mandated, primarily because of uncertainties in the international commodity and financial markets. Global oil price movements remain volatile, even though oil futures indicate stabilisation of prices until the end of the year and a slight decrease by the end of 2019. Given the rise in global oil prices, inflation in the international environment is likely to be somewhat higher this year. Also, the expected further monetary policy tightening by the Fed and a wind-down of the QE programme by the ECB in the remainder of the year could affect capital flows to emerging markets. Uncertainties are also associated with geopolitical and trade tensions and their possible effect on global economic growth and volatility in the commodity and financial markets. Nevertheless, the Executive Board points out that the resilience of our economy to potential negative effects from the international environment has increased, owing to improved macroeconomic indicators and overall prospects.

The next rate-setting meeting is scheduled for 8 October.

Press release from Executive Board meeting held on 8 October 2018

At its meeting today, the NBS Executive Board voted to keep the key policy rate on hold, at 3.0%.

In making such decision, the Executive Board was guided by the expected movement in inflation and its underlying factors, and the effects of past monetary policy easing. After reaching this year's low in April, inflation returned within the target tolerance band, in line with expectations, and touched 2.6% in August. The Executive Board expects that year-on-year inflation will continue to move within the target tolerance band in the next two years. In the medium run, it will be driven mainly by the gradual rise in aggregate demand. Both the financial and corporate sectors expect that the achieved price stability will be maintained in the coming period, as reflected in their inflation expectations anchored around the 3% target for both one and two years ahead.

The Serbian economy has been rising vigorously since the start of the year, at the highest rate in the past ten years, aided also by the past monetary policy easing of the NBS. As assessed by the Executive Board, economic growth will exceed 4% this year, with a significant contribution coming from investment, which will ensure the continuation of vibrant growth in manufacturing exports going forward. The investment upturn is also supported by favourable financing conditions and lending growth. Furthermore, the net FDI inflow, which comfortably covers the current account deficit, is contributing to a reduction in external imbalance in the medium term through the impact on export growth.

The Executive Board judges that caution in monetary policy conduct is still mandated, primarily because of developments abroad. Global oil price movements remain volatile, even though oil futures indicate the stabilisation of prices until the end of the year. Given the rise in global oil prices, inflation in the international environment is also somewhat higher this year. The expected further monetary policy tightening by the Fed and a wind-down of the QE

programme by the ECB in the remainder of the year could affect capital flows to emerging markets. Besides, growing protectionism in international trade has dampened investor mood and stirred uncertainties in the international financial market. Nevertheless, the Executive Board points out that the resilience of our economy to potential negative effects from the international environment has increased, owing to improved macroeconomic fundamentals and overall prospects.

The next rate-setting meeting is scheduled for 8 November.

Press release from Executive Board meeting held on 8 November 2018

At its meeting today, the NBS Executive Board voted to keep the key policy rate at 3.0%.

In making this decision, the Executive Board took into account the expected movement in inflation and its underlying factors going forward, and the effects of past monetary policy easing.

Inflationary pressures remained low even in conditions of strong economic growth. Inflation continued to move within the target tolerance band, measuring 2.1% in September. According to our November central projection, year-on-year inflation will remain low and stable, moving in the target tolerance band (3.0±1.5%) until the end of the projection horizon, i.e. in the next two years. In the medium-term, inflation movements will be primarily determined by the gradual rise in aggregate demand. Both the financial and corporate sectors expect that the achieved price stability will be maintained, as signalled by their inflation expectations anchored around the 3% midpoint for both one and two years ahead.

The Executive Board estimates that the effects of the past monetary policy easing have contributed to the acceleration of economic growth, which in the year to date posted the highest rate in the past ten years – 4.5% year-on-year. A high impetus to growth came from investment, which will continue to spur manufacturing exports in the coming period. Investment growth is supported by favourable financing conditions and a rise in lending. Also, the net inflow of foreign direct investment, which more than fully covers the current account deficit, reflects positively on export growth and narrows external imbalances in the medium-term.

The Executive Board judges that caution in monetary policy conduct is still mandated, primarily because of developments in the international environment. Global oil prices are volatile and therefore uncertain for the period to come. Judging by futures, oil prices are likely to stabilise until end-2018 and trend somewhat lower until end-2019. Inflation in the international environment is also somewhat higher this year – chiefly due to the global oil price increase. The expected further rate hikes by the Fed and the wind-down of the QE programme by the ECB in the remainder of the year could affect capital flows to emerging markets. In addition, rising protectionism in international trade fuelled uncertainty in the international financial market, which could diminish investors' readiness to invest. Nevertheless, the Executive Board points out that the resilience of our economy to potential negative effects from the international environment has increased, owing to improved macroeconomic indicators and prospects going forward.

At its meeting today, the NBS Executive Board adopted the November Inflation Report, which will be presented to the public on 16 November. On this occasion, monetary policy decisions and the underlying macroeconomic developments will be explained in more detail.

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

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