



National Bank of Serbia

November  
2019

# INFLATION REPORT



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**NATIONAL BANK OF SERBIA**

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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 7 November 2019.

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

Executive Board of the National Bank of Serbia:

Jorgovanka Tabaković, Governor

Željko Jović, Vice Governor

Ana Ivković, Vice Governor

Dragana Stanić, Vice Governor

## **ABBREVIATIONS**

**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  
**GVA** – gross value added  
**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

Global growth continued to decelerate and hence the growth forecasts for this year for leading world economies, including the euro area (our main foreign trade partner) were again revised downwards. Relevant international institutions also scaled down their global growth forecast for the next year, estimating that growth would, nevertheless, gradually pick up in the period ahead. The international financial and commodity markets are largely affected by protectionist measures and uncertainty surrounding trade policies of leading world economies, which has a negative impact on business confidence and investor sentiment. On the other hand, amid low inflationary pressures global economic growth is supported by monetary policy accommodation of leading central banks, which should diminish the spill-over of stronger negative effects into the international commodity and financial markets and at the same time reduce pressures towards emerging markets' monetary policy tightening or make room for their easing. The additional monetary stimulus by leading central banks resulted in a lower risk premium for the majority of emerging markets, with the fall in Serbia's risk premium being the sharpest relative to other countries in the region, thus indicating that the fall was triggered by both global and domestic factors. In September, Serbia's risk premium fell below 50 bp, its lowest level on record. This is also confirmed by Serbia's credit rating upgrade by Fitch and coming close to investment grade, as well as by the improvement of the rating outlook by Moody's.

As in other regional peers, y-o-y inflation in Serbia followed a downward trajectory in Q3, reaching 1.1% in September, due to the lower contribution of the prices of food, primarily vegetables at the beginning of the new agricultural season, and energy prices. Core inflation, in the range of 1.2–1.5% y-o-y since early this year, points to the more lasting nature of low inflationary pressures, even in conditions of positive labour market trends. At the same time, inflation expectations of the financial and corporate sectors, moving in the lower half of the target band, indicate, consistent with the NBS projection, that inflationary pressures will remain low in the period ahead.

Against the background of low inflationary pressures underpinned by the majority of factors in the domestic and international environment, the NBS continued to support the economic growth by cutting the key policy rate to the new lowest level in the inflation targeting

*In the period since the August Report, international environment has been marked by the slowdown in global trade, growth and inflation, with additional accommodative measures of leading central banks aimed at cushioning the adverse effects of rising protectionism and geopolitical tensions.*

*In accordance with expectations and NBS announcements, y-o-y inflation slowed down as of May, mostly in response to the lower contribution of vegetable prices with the onset of a new agricultural season and lower prices of petroleum products.*

*Robust lending growth at favourable financial conditions contributes significantly to the economic growth, without jeopardising the sustainability of price and financial stability.*

regime (2.25%). Owing to monetary policy easing, persistently low interest rates in the international money market, a lower country risk premium and increased interbank competition, financial conditions in the private sector remained favourable. This enabled a two-digit y-o-y rise in lending which is currently more oriented towards the corporate sector. The structure of lending is conducive to sustainable economic growth, as testified by a significant rise in investment loans to corporates and the recovery of housing loans to households, with a slight slackening of the growth in loans intended for consumption. Owing to the efforts aimed at solving the NPLs, their share in total loans fell below 5%, making room for a further rise in lending and reinforcing financial stability.

*Despite robust support to economic growth, notably to higher investments, the trend of good fiscal results keeps up, contributing to a further reduction in the share of public debt in GDP.*

Favourable fiscal trends continued on the back of full coordination of monetary and fiscal policies and successfully implemented fiscal consolidation. By the end of September general government fiscal surplus reached RSD 35.1 bn and the primary surplus RSD 131.9 bn, despite significantly higher government capital expenditures and increased outlays for salaries and pensions. Favourable fiscal trends are underpinned by economic growth, increased corporate profitability and positive labour market trends. Owing to the elimination of fiscal imbalances, the share of public debt in GDP was brought down within sustainable bounds. At end-September central government debt amounted to 52.0% of the projected GDP (vs. 53.7% at end-2018). Such downward trend is expected to continue in the coming period. No less important is the fact that the currency risk and the risk of refinancing are mitigated thanks to the government opting mostly for borrowing at home by issuing long-term dinar securities, as well as to the maturing and early payment of a part of the debt under dollar-denominated eurobonds, and the achieved lower interest rates on such borrowing. This is also confirmed by yet another successful issuance of the ten-year eurobond in the international financial market in the amount of EUR 550 million, whereby a portion of expensive dollar debt was replaced with significantly cheaper financing in euros at the interest rate of 1.25%, which is even lower than in June.

*This year's balance of payments trends are under the impact of the country's investment cycle and the slowdown in external demand.*

Serbia's exports keep posting relatively high growth rates despite many challenges in the international environment – preliminary data show that the export of goods and services in the first nine months of 2019 is 10.9% higher than in the same period last year. At the same time, in the face of considerably weaker EU demand, 10.6% more goods and services were exported to this market than in the same period of 2018. Thus, the overall export growth

rate approached the import growth rate (11.6% y-o-y), the latter being driven by the ongoing investment cycle and hence greater needs for intermediate goods and equipment, as well as by the stronger consumer demand. The rise in imports, associated also with the high FDI inflow, has resulted in a higher current account deficit. However, since imported equipment will increase the exporting capacities of the Serbian economy, it is reasonable to expect that the share of the current account deficit in GDP will decrease in the medium term. The pace of this decrease will depend on the investment cycle dynamics and the pertinent import of equipment and industrial raw materials.

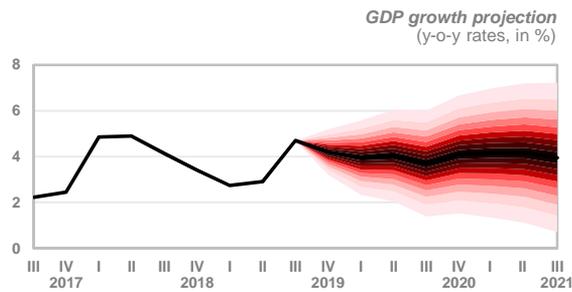
For the fifth consecutive year, the current account deficit is fully covered by the net FDI inflow. According to preliminary data for nine months, the FDI inflow of around EUR 2.9 bn is project-diversified and for quite some time now channelled mainly to tradeable sectors, thus contributing to the country's external sustainability and sound economic growth. Foreign investors' increased interest in government securities in the Serbian market resulted in a net inflow of almost EUR 200 mn from portfolio investment. Such developments in cross-border trade and financial transactions resulted in the EUR 1.7 bn increase in FX reserves, pushing them to EUR 13.3 bn at end-September and additionally boosting our economy's resilience to external shocks.

GDP growth in Q3 surprised on the upside, reaching 4.7% y-o-y (1.8% s-a) owing to the recovery of manufacturing after the completed overhauls at the oil and chemical industries and the activation of prior investments, as well as to the pick-up in construction and services. In Q4 economic growth is likely to maintain its relatively strong dynamics, and equal 3.6% for the year as a whole, instead of the previously expected 3.5%. On the expenditure side, investments remained a key factor of economic growth, thanks to the continued realisation of infrastructure projects and private sector investments attributable to the improved business environment and favourable sources of funding. Another proof of Serbia's improved business environment is the country's progress on the latest Doing Business list, where it climbed four places and is now ranked 44<sup>th</sup> of 190 countries. Investment growth spills over onto other demand components. Household consumption continues up on the back of prolonged favourable developments in the labour market – new job creation, rising wages, notably in the private sector, unemployment rate approaching a single-digit level, as well as lower costs of borrowing. On the other hand, the investment cycle in Serbia and the associated import of equipment, as well as the further slowdown in external

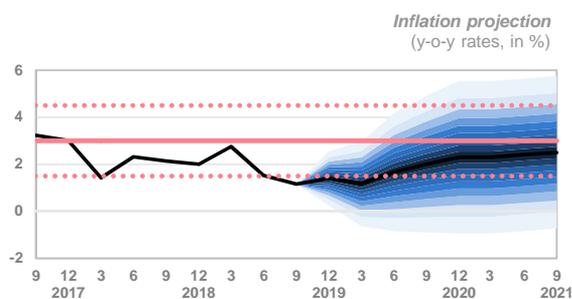
*As in the past four years, this year the current account deficit is fully covered by the net FDI inflow, and we expect it to remain so in the coming period as well.*

*For the fifth consecutive year, economic activity has recorded a positive growth rate and, relative to the first part of the year, it has accelerated more than anticipated. We therefore estimate that this year's GDP growth will be 3.6%.*

**We expect GDP growth to accelerate to around 4% in 2020 and maintain similar dynamics in the medium term, driven by investment, exports and sustainably rising household consumption.**



**Y-o-y inflation will hover around the lower bound of the target tolerance band until end-2019 and in H1 2020. Thereafter, we expect it to gradually converge to the central midpoint until the end of the projection horizon.**



demand, reflect negatively on the contribution of net exports, though it is lower than in the first half of the year owing to a step-up in manufacturing exports.

Our GDP growth projection for 2020 includes an acceleration to 4.0%, and the same rate is expected in the medium term. On the production side, in 2020 a positive contribution is expected from all sectors, except agriculture, assuming an average agricultural season. At the same time, growth should speed up mostly on account of the industry, due to higher investments in export-oriented sectors, as well as the base effect, i.e. the fact that this year's industrial production was affected by weaker external demand, introduction of 100% tariffs on products delivered to Kosovo and Metohija and the overhauls at the oil and chemical industries. On the expenditure side, GDP rise in 2020 will be fully driven by domestic demand, i.e. continued investment and final consumption growth, while the FDI inflow, channelled mostly to tradeable sectors and the increase in production capacities, with the anticipated mild rise in external demand, will facilitate faster growth in exports and diminish the negative contribution from net exports. Medium-term risks to the GDP projection are judged to be symmetric, with risks stemming from the international environment assessed as skewed to the downside, mostly due to the global slowdown, while those arising at home as tilted to the upside, mostly on the grounds of the possibly faster investment growth than previously expected, as was the case in 2018 and 2019.

Under the November central projection, we expect y-o-y inflation to hover around the lower bound of the target tolerance band until end-2019 and in the first half of 2020, mainly under the influence of the high base effect from vegetable prices. Afterwards, the base effect from vegetable prices will act in the opposite direction. Together with the rising aggregate demand and the anticipated acceleration in administered price growth, this will result in the gradual convergence of inflation to the central midpoint. Over the projection horizon, i.e. the upcoming two years, inflation should remain below the 3% midpoint amid the still low cost-push pressures and the assumed mild decrease in the global oil price in accordance with futures movements. Relative to the projection in our *August Report*, the new medium-term inflation projection is lower until mid-2020 and then somewhat higher until the end of the projection horizon. The main reason for the lower inflation projection until mid-2020 lies in the sharper than expected y-o-y decrease in vegetable prices in Q3, which reduced the projected y-o-y inflation rates until mid-2020 and increased them thereafter on account of the base effect. Uncertainty

surrounding the inflation projection is associated primarily with movements in international commodity and financial markets, and administered price growth to an extent. Taken together, the risks to the projection are judged to be symmetric.

Monetary policy decisions in the coming period will continue to depend on the assessment of the effects of past monetary policy easing on inflation movements going forward, and the impact of other domestic and external factors. Given that the key risks to the projection still largely emanate from the international environment, the NBS will continue to carefully monitor and analyse trends in the international commodity and financial markets, and 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 run, at the same time maintaining financial stability and contributing to sustainable economic growth and preservation of macroeconomic stability.

*It is assessed that key risks in the period ahead will emanate from the international environment and, as such, they may affect the monetary policy stance.*



## II Monetary policy since the August Report

*In the period since the August Inflation Report, the key policy rate was trimmed by 25 bp in November, to 2.25%, its lowest level in the inflation targeting regime. In setting the key policy, the NBS Executive Board took into account the expected movements in inflation and other macroeconomic indicators at home and abroad in the period ahead, as well as the lowering of the key policy rate by a total of 50 bp in July and August this year.*

*Domestic conditions in which monetary policy was implemented were characterised by the inflation kept firmly under control for the sixth year in a row and the sustainability of the results achieved in narrowing fiscal and external imbalances. However, the conditions in the international environment still mandated caution. Although monetary policies of leading central banks became more accommodative, it is uncertain to what extent they will diverge from market expectations in the period ahead, which could affect capital flows towards emerging markets, Serbia included. There is also uncertainty regarding movements in the prices of oil and other primary commodities in the global market. 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.*

**In deciding to keep the key policy rate unchanged in September and October**, the NBS Executive Board had in mind that **domestic factors exerted a favourable impact on economic activity and inflation, while international developments warranted caution** in the conduct of monetary policy. Also, it took into account that the full effects of the past monetary policy easing were yet to manifest.

Domestic macroeconomic conditions in which monetary policy was implemented remained favourable. Inflation was kept firmly at bay for the sixth year in a row and, consistent with the Executive Board's announcements, after reaching the target midpoint in April, it had a downward trajectory, mainly as a result of the lower contribution of vegetable prices with the onset of a new agricultural season. The Executive Board emphasised that, as in the past years, inflation would be low and stable in the period ahead, as confirmed in the August inflation projection, which was the basis for deciding on monetary policy in this period. Keeping inflation at a low and stable level was underpinned by the still low cost-push pressures and viable growth in aggregate demand. Low inflationary pressures are indicated by both short- and medium-term inflation expectations of the financial and corporate sectors, which moved in the lower part of the target tolerance band in Q3.

As assessed by the Executive Board, in the medium term inflation would approach the target midpoint mainly owing to the gradual rise in domestic demand. Namely, economic growth and the continuation of positive labour market trends, characterised by the rise in wages and employment and the drop in the unemployment rate, will prop up the rise in domestic demand. Domestic demand growth has also been supported by the NBS's past monetary policy easing through lower interest rates on new dinar loans, and lower costs of repayment of outstanding loans, which reflected positively on the private sector's disposable income. The achieved and sustained stability of the financial system and relative stability of the domestic currency, coupled with the lowest on record share of NPLs in total loans opens the room for further lending and economic growth. In addition, interest rates on euro-indexed loans are still low, aided by the increased ECB's monetary accommodation, as well as by stronger interbank competition and a further decline in Serbia's risk premium.

Overall macroeconomic stability and development prospects of the country have been also underpinned by positive fiscal movements. A significant increase in government capital expenditure and the planned rise in public sector wages and pensions represent sources of financing investments and consumption, though not to

the extent that would cause major inflationary pressures and disrupt the downward trajectory of the share of public debt in GDP. As in the past two years, fiscal discipline has resulted in a consolidated budget surplus since the start of the year and a reduction in the central government public debt-to-GDP ratio to 52.0% in September. Favourable fiscal trends are underpinned by economic growth, increased corporate profitability and positive labour market trends.

Speaking of economic activity, the August projection kept the GDP growth forecast for 2019 unchanged (3.5%), while GDP was expected to pick up in the medium-term, to around 4%, led by investment, exports and household consumption rising on sustainable grounds. Economic indicators signalled an increase in the oil and chemical industries after the completion of overhauls, which, coupled with the further rise in construction and services, should lead to accelerated GDP growth in the remainder of the year. As a result of the activation of investments in tradeable sectors, the export of goods and services continues to grow at two-digit rates, despite the slowdown in the global economy, primarily in the euro area. Consistent with the investment cycle, the imports structure is dominated by equipment and intermediate goods, which are necessary for the future growth of export-oriented output. That is why the Executive Board expects gradual improvement in Serbia's external position in the period ahead, with the current account deficit fully covered by FDI inflow.

Robust FDI and portfolio inflows confirm Serbia's economic growth sustainability and stronger investor confidence. This is supported by the fact that Serbia's risk premium was among the lowest in the region, falling to below 50 bp in September, its lowest level on record. A confirmation of the achieved progress and favourable growth outlook came also from rating agencies in September. After Moody's upgraded its outlook on Serbia from stable to positive, Fitch Ratings upgraded Serbia's Long-Term Foreign- and Local-Currency Issuer Default Ratings to BB+. Therefore, by preserving stability and transforming its economy, the Republic of Serbia has come, for the first time, only a step below investment grade, characteristic of economies offering a high security of investment. Not only is this a confirmation of the economic progress and the results achieved by the Republic of Serbia, but it also contributes to further improvement of financing conditions and the growth of investments in Serbia.

Unlike favourable macroeconomic conditions at home, the developments in the international environment still mandated caution in the conduct of monetary policy. The international financial and commodity markets are heavily influenced by protectionist measures and uncertainties surrounding trade policies of major world economies. Trade tensions continued to undermine business confidence and investor sentiment, increasing concerns that this could have a more serious negative impact on investment and economic growth at the global level. Support to the global economy came from the monetary policies of leading central banks. In September, the ECB additionally lowered the deposit facility rate in the negative territory, starting the implementation of a new, third series of longer-term refinancing operations (TLTRO III), effective until March 2021, to preserve banks' favourable lending conditions. It also reintroduced the asset purchase programme, which will commence in November, with a monthly net purchase of EUR 20 bn. Consistent with expectations, the Fed cut its key rate again in September, which should have a positive impact on the global financial conditions. Also, for the first time in more than ten years, the Fed began injecting liquidity through repo operations in September to ease money market pressures and keep its rate in the target range. The anticipated new cycle of monetary policy easing of leading central banks should favourably affect the conditions in the international financial market and capital flows to emerging markets, and therefore to Serbia. However, it remains uncertain to what extent the monetary policies of leading central banks would differ from market expectations, which might affect capital flows toward emerging markets. Monetary policy decisions of the Executive Board also called for caution over the uncertain pace of the global prices of oil and primary agricultural commodities, considering the intricate impact of numerous factors – on both the supply and demand side.

The Executive Board stressed that trends in the international financial and primary commodity markets, especially markets of crude oil and primary agricultural commodities, will continue to be closely monitored and analysed. The resilience of the Serbian economy to potential adverse effects from the international environment has increased, owing to more favourable macroeconomic indicators and prospects. As so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium term. Together with maintaining financial stability, this will contribute to sustainable economic growth and

strengthen the country's resilience to external uncertainties. Serbia's FX reserves rose to EUR 13.3 bn at end-September, further fortifying our resilience to risks from the international environment.

Starting from the November inflation projection, which indicated that inflationary pressures weakened further, the Executive Board **decided in its November meeting to trim the key policy rate by 25 bp, to 2.25%**. Under the November central projection, inflation will move around the lower bound of the target tolerance band until the end of this year and in H1 next year, and its gradual approach to the target midpoint is expected in the medium run, driven by rising aggregate demand. Low inflationary

pressures are also indicated by core inflation, which remained low and stable, and by a further decline in the inflation expectations of the financial and corporate sectors. Besides favourable domestic macroeconomic conditions of monetary policy conduct, the NBS Executive Board's decision to further cut the key policy rate was also motivated by trends in the international environment, mainly the slowdown in global trade and economic growth and an increase in monetary policy accommodation by leading central banks, which should have a positive impact on capital flows toward emerging markets. In addition, inflationary pressures remain subdued in the international environment, notably in the euro area, our most important foreign trade partner.



### III Inflation movements

In the period since the August Report, inflationary pressures on both the demand and cost side remained low, despite the continued rise in wages, primarily in the private sector. Y-o-y inflation was on a downward path during Q3, measuring 1.1% in September. Such inflation movements were predominantly driven by a lower contribution from fresh vegetables prices, with the onset of the new agricultural season, and by the fall in the prices of petroleum products resulting from a decline in global oil prices. Low inflationary pressures are also indicated by the low and stable core inflation (1.3% in September), as well as by the inflation expectations of the financial and corporate sectors, which move in the lower part of the target band for both one and two years ahead.

The quarterly dynamics of inflation movements was also driven by a notable decline in the prices of fresh vegetables and petroleum products, while the greatest positive contribution to consumer prices in Q3 came from the cigarette price hike.

#### Inflation movements in Q3

In Q3, inflation additionally slowed down, measuring 1.1% y-o-y in September, mostly due to a lower contribution from fruit and vegetables prices (from 0.2 pp in June to -0.3 pp in September) in the new agricultural season, and lower prices of petroleum products (-0.2 pp in September) resulting from the fall in global oil prices. On the other hand, the largest positive contribution to y-o-y inflation in September came from the cigarette price hike (0.3 pp) and from certain services (transportation and travel packages), with a 0.3 pp cumulative contribution to inflation. Core inflation, as the part of the CPI which is most affected by the monetary policy, remained low and stable, measuring 1.3% y-o-y in September, consistent with expectations in the August *Inflation Report*.

At quarterly level, **consumer prices decreased by 0.7% in Q3**. The prices of **food and non-alcoholic beverages** decreased by 2.4%, affected by the sharper seasonal cheapening of fresh vegetables (-26.8%), giving a 1.1 pp negative contribution to quarterly inflation. On the other hand, prices of fresh meat and fruit increased in Q3 by 2.3% and 1.7% respectively, giving a cumulative 0.1 pp contribution to inflation. As opposed to the **unprocessed food** prices, the prices of **processed food** recorded a quarterly rise (0.9%, contribution: 0.2 pp), on account of the higher prices of bread and cereals, meat products and confectionery, and generated a 0.1 pp cumulative contribution to inflation.

**Energy prices** decreased in Q3 (-0.3%), as a result of the fall in domestic **petroleum product prices** (-1.6%),

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

	2019		Difference
	June	Sept.	
<b>Consumer prices (CPI)</b>	1.5	1.1	-0.4
Unprocessed food	0.3	-0.2	-0.5
<i>Fruit and vegetables</i>	0.2	-0.3	-0.5
<i>Fresh meat</i>	0.0	0.1	0.1
Processed food	0.2	0.5	0.3
Industrial products excluding food and energy	0.4	0.4	0.0
Energy	0.1	-0.1	-0.2
<i>Petroleum products</i>	0.0	-0.2	-0.2
Services	0.6	0.6	0.0

Sources: SORS and NBS calculation.

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

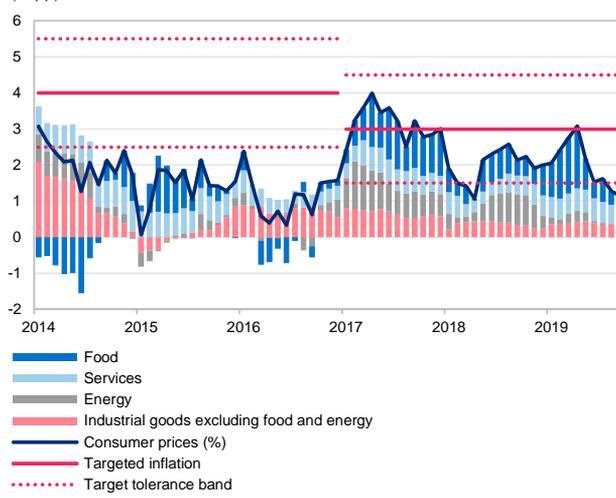
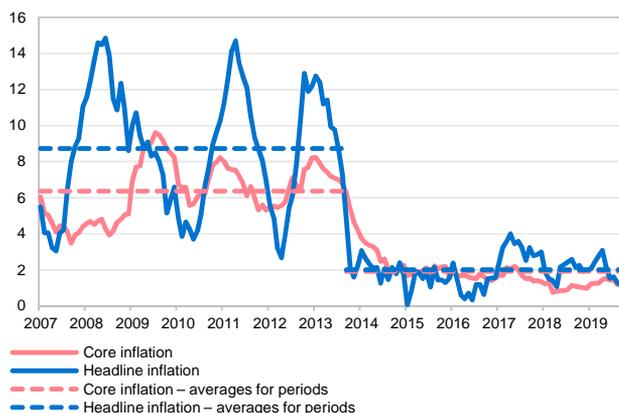


Chart III.0.2 **Headline and core inflation**  
(y-o-y rates, in %)



Sources: SORS and NBS calculation.

Table III.0.2 **Growth and contribution of components to consumer price growth in Q3 2019**

	Growth rates (%)	Contribution (pp)
<b>Consumer prices (CPI)</b>	<b>-0.69</b>	<b>-0.69</b>
Unprocessed food	-8.60	-0.95
Processed food	0.88	0.18
Industrial products excluding food and energy	0.00	0.00
Energy	-0.26	-0.04
Services	0.45	0.11
<b>CPI excluding energy, food, alcohol and cigarettes</b>	<b>-0.12</b>	<b>-0.05</b>
<b>Administered prices</b>	<b>1.03</b>	<b>0.19</b>

Sources: SORS and NBS calculation.

contribution: -0.1 pp), which mirrored the movement in their global counterparts. The increase in the prices of solid fuels worked in the opposite direction to the same degree, providing a negligible contribution to quarterly inflation.

The upward pressure on consumer prices in Q3 came from the cigarette price hike (3.6%, contribution: 0.2 pp), but it was fully neutralised by the seasonal decline in the prices of clothes and footwear (-2.3%) and lower prices of furniture, vehicles and car parts, audio and TV devices (with a -0.2 pp cumulative contribution to inflation). Thus, the **prices of industrial products excluding food and energy stagnated in Q3**.

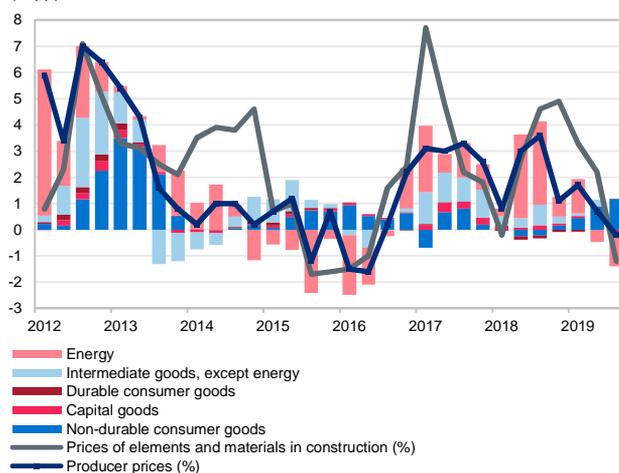
A 0.4% rise in the **prices of services** in Q3 (0.1 pp contribution) was driven by the increase in the prices of rents, apartment maintenance and repair services, catering, as well as medical and transportation services. The seasonal decline in the prices of travel packages in Q3 worked in the opposite direction (-1.7%).

The **administered prices** growth of 1.0% in Q3 (0.2 pp contribution) is almost entirely attributable to the July and August cigarette price hikes, which also largely determined the 2.3% y-o-y growth of administered prices in September.

**The prices within core inflation** (CPI excluding food, energy, alcohol and cigarettes) decreased slightly in Q3 (-0.1%, with a negligible contribution to inflation), chiefly on account of the seasonal decline in the prices of clothes and footwear.

## Producer and external prices

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



Sources: SORS and NBS calculation.

\* Industrial producer prices for the domestic market.

In the period since the *August Report*, cost-push inflationary pressures remained low. **Industrial producer prices in the domestic market** declined by 0.1% in Q3, ending September 0.2% lower y-o-y (for the first time since June 2016). In y-o-y terms, the reduction in the **energy production prices** (primarily domestic crude oil and petroleum products) was neutralised by the higher **prices of non-durable consumer goods**, due to higher costs of food and beverage production. Compared to Q2, the **prices of intermediate and capital goods** gave a negative contribution to domestic producer prices in Q3 (-0.1 pp each), leading to their y-o-y decline, while the prices of durable consumer goods remained unchanged. Beside producer prices, the **prices of elements and materials incorporated in construction** fell by 2.4% in Q3, slowing down their y-o-y growth to 1.2% in September.

After stagnating in Q2, dinar-denominated **import prices**<sup>1</sup> fell by 0.7% on average in Q3. Y-o-y, they fell by 0.5% on average, driven chiefly by the significantly lower oil price denominated in the US dollar in Q3 (17.9% on average) compared to the same period last year (-0.7 pp contribution). A negative contribution (0.2 pp) also stemmed from lower prices of German exports (which are used to approximate prices of imported equipment and intermediate goods). On the other hand, a positive contribution came from higher global food prices denominated in the US dollar (0.3 pp) and consumer prices in the euro area (0.1 pp), which are used to approximate prices of import services. As in Q2, the euro's slide vis-à-vis the dollar also affected the dynamics of the prices of imported goods and services in Q3.

### Inflation expectations

The results of inflation expectation surveys indicate that the financial and corporate sectors expect that inflation will be low and stable both in the short and medium term, and that it will move in the lower part of the target band, consistent with the NBS projections. Expectations edged down during Q3 compared to Q2, most probably owing to the current inflation slowdown.

According to the Ipsos survey results, the **financial sector** expects that inflation will move in the range 2.0–2.5% in Q3 and October 2020. At the same time, the results of the Bloomberg survey indicate that after touching 2.9% in July, short-term inflation expectations of the financial sector fell in the following months to 2.1% in November. Looking at the longer horizon, the financial sector has expected price stability and inflation within the NBS target tolerance band for six years now (since October 2013). Another indicator of decreasing uncertainty regarding future inflation is the lower dispersion of individual expectations of financial sector representatives, which further contributes to the anchoring of inflation expectations.

**One-year ahead inflation expectations of corporates dropped** from 2.5% in July to 1.6% in October. Two thirds of corporates expect that the price of production inputs will not change over the next twelve months.

**One-year ahead inflation expectations of the household sector** are typically higher than those of other

<sup>1</sup> The weighted average of the global Brent oil price and food price index (FAO index), euro area consumer prices, and export prices of Germany, one of Serbia's most significant foreign trade partners, is used as an indicator of import prices.

Chart III.0.4 Contribution of individual components to y-o-y growth rate of import prices in dinars (in pp)

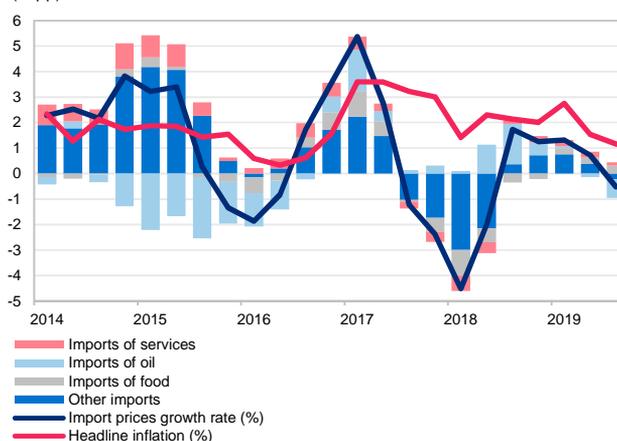


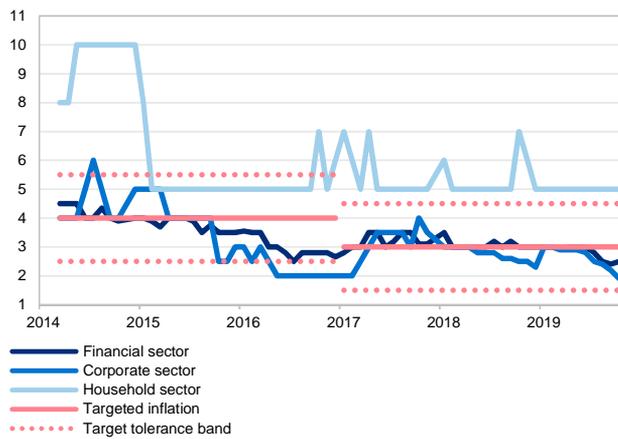
Chart III.0.5 Current inflation and one-year ahead inflation expectations (y-o-y rates, in %)



Chart III.0.6 Household perceived and expected inflation\* (in index points)



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



Sources: Ipsos/Ninamedia and NBS.

\* Ipsos until December 2014, Ninamedia since December 2014, and Ipsos since January

sectors, standing stable at 5.0% in Q3 and October. On the other hand, the results of the qualitative survey of household inflation expectations<sup>2</sup> show that the index of expected inflation continued to record lower values than the index of perceived inflation, indicating that households expect that prices will not rise as much over the next 12 months as in the past year.

**Two-year ahead inflation expectations of the financial sector** are anchored within the NBS target tolerance band since their monitoring began (March 2014), standing at the 3.0% target midpoint since October 2018, only to decline in recent months. They came at 2.8% in July, and then moved in the range 2.4–2.5% in the period August–October. **Medium-term inflation expectations of the corporate sector** have moved within the target tolerance band since August 2014, declining in recent months from 2.5% in July to 1.9% in October. Two-year ahead inflation expectations of households have been stable at 5.0%.

<sup>2</sup> For more details on qualitative expectations of households see the February 2016 Inflation Report –Text box 2, p. 15.

## IV Inflation determinants

### 1 Financial market trends

*Continued monetary policy easing led to a further fall in money market interest rates, which reflected also on the lowering of interest rates on new loans to corporates and households in Q3. Supported by more favourable foreign trade trends and capital inflows, appreciation pressures on the dinar extended into Q3.*

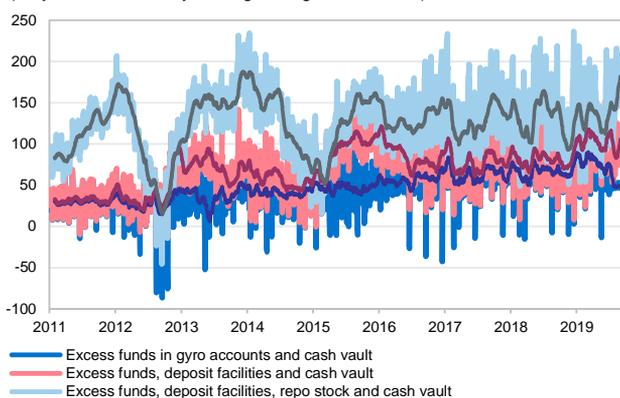
#### Interest rates

The average rate on one-week repo operations followed the downward path of the key policy rate and was almost equal to the deposit facility rate throughout Q3. At end-September it stood at 1.27% and was 0.5 pp lower than at end-June.

Amounting to RSD 3.8 bn in Q3, the average daily turnover in the overnight interbank money market was only slightly higher than a quarter earlier. Consistent with the key policy rate cuts, BEONIA was on the decline in the course of Q3, with the average September value of 1.28%, which is 0.6 pp lower than in June. BELIBOR rates of all maturities were also on the decline in Q3, the decline being sharper than the key policy rate cut in the case of longer maturities. BELIBOR rates ranged between 1.4% and 2.1% in September, losing from 0.8 pp for shorter maturities to 1 pp for the three- and six-month maturity relative to June. In the course of October, BEONIA and BELIBOR rates of all maturities exhibited minimum volatility and their values remained almost unchanged from a month earlier.

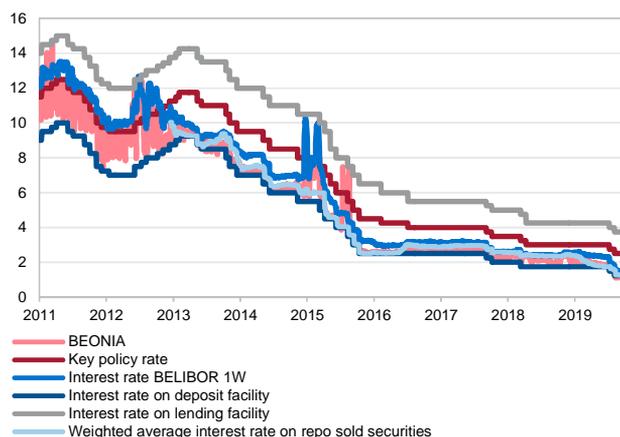
Better than planned fiscal results in 2019 helped to reduce government needs for borrowing in the domestic market of **dinar securities** in Q3. Thus, only one auction of the benchmark seven-year bond was organised each month. The first auction held in July was significantly oversubscribed, which together with investors' greater readiness to accept lower yields resulted in a 0.8 pp interest rate decrease relative to June, to 3.6%. In the other two auctions held in Q3, demand was slightly

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



Source: NBS.

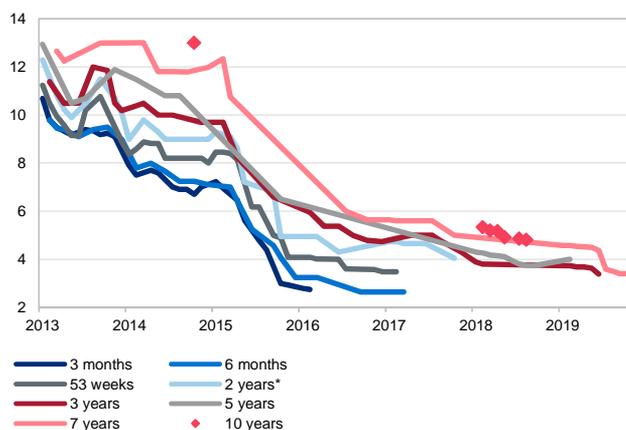
Chart IV.1.2 Interest rate movements  
(daily data, p.a., in %)



Sources: Thomson Reuters and NBS.

Chart IV.1.3 Interest rates in the primary market of dinar government securities

(p.a., in %)



Source: Ministry of Finance.

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

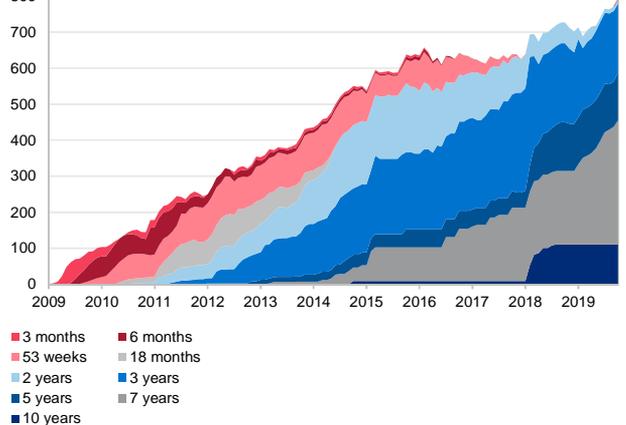
weaker, but the interest rate continued down, reaching 3.4% in September.

Securities worth nominal RSD 38.0 bn were sold during Q3. As in the same period RSD 9.1 bn worth of securities fell due for payment, the stock of sold dinar securities increased by RSD 28.9 bn, to RSD 770.7 bn. Non-residents expanded their portfolio of dinar securities by RSD 13.0 bn, mainly by investing in the seven-year dinar bond in the July auction. As a result, they came to hold 32.1% of total dinar securities sold.

Another auction of seven-year bonds was held in early October and the interest rate remained unchanged. Though the plan was to sell securities worth RSD 7.0 bn, due to stronger demand the government sold securities worth nominal RSD 17.3 bn, one quarter of which to non-residents.

Chart IV.1.4 Stock of sold dinar government securities

(in RSD bn)



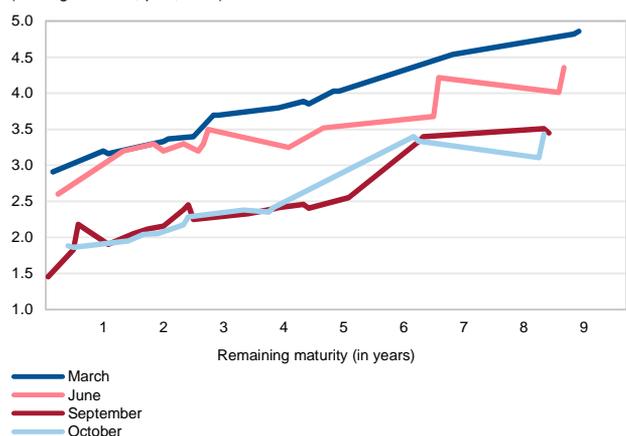
Source: Ministry of Finance.

The **secondary market** saw greater investor activity, indicated also by the rise in trading volumes from RSD 95.0 bn in Q2 to RSD 124.8 bn in Q3. The key policy rate cut spilled over to the yield rates, which declined from June (by up to 1.0 pp), ranging in September from 1.5% for the one-month maturity to 3.5% for the 8.5-year (100-month) maturity. There were no major changes in the secondary market yield rates in October.

There were no auctions of **euro-denominated securities** in the course of Q3. Two auctions were held in October – auctions of ten- and three-year securities. Interest rates went down, especially the rate on ten-year bonds. Its 1.4 pp fall to 1.9% can be attributed to the recently held auction of ten-year eurobonds in the international financial market, where the rate plunged to 1.6%. The rate on three-year bonds also dipped – by 0.55 pp to 0.6%.

Chart IV.1.5 Yield curve in the secondary government securities market

(average values, p.a., in %)



Source: Central Securities Depository and Clearing House.

Consistent with the movement in money market interest rates, the **interest rates on new dinar loans to corporates and households** posted a decline. The weighted average interest rate on new corporate loans lost 0.7 pp from June, equalling 4.4% in September. The fall was registered for all types of loans. The interest rate on new household loans came at 9.6% in September, inching down by 0.2 pp relative to June. Interest rates on new cash loans to households went down to the same degree, averaging 9.8% in September.

The weighted average **interest rate on euro-denominated corporate loans** edged down by 0.2% from June, to 2.6% in September. Interest rates declined for all types of corporate euro loans. Investment loans and current assets loans were approved in September at the average rate of 2.8% and 2.7%, respectively.

In September, **euro-indexed household loans** were approved at the average rate of 3.8%, 0.5 pp higher than in June. This rise in the interest rate can be put down to a significantly smaller share of new euro-indexed housing loans in total euro-indexed household loans in September relative to June, when the share of these loans recorded a one-off increase amid implementation of the Law on the Conversion of Housing Loans Indexed to Swiss Francs. This is also evidenced by the fact that the interest rate on euro-indexed housing loans fell by 0.2 pp, to 2.8% in September.

Interest rates on **time dinar deposits** decreased in Q3. Thus, the rates on household dinar savings edged down by 0.2 pp to 2.8%, and those on corporate time deposits fell by 0.6 pp to 2.0% in September. On the other hand, interest rates on household euro savings remained unchanged from June (at 0.9%), while those on corporate time deposits climbed by 0.4 pp to 0.7% in September.

### Risk premium

Despite the negative effect of the global economic slowdown on emerging markets, the risk premia of these countries recorded a further decline in Q3, most probably on the back of monetary policy easing by leading central banks. Relative to end-Q2, EMBI Global Composite fell by 43 bp to 323 bp and EMBI Europe by 16 bp to 291 bp at end-October.

Looking at the region, the sharpest fall in Q3 was recorded by Serbia, whose risk premium plunged by 25 bp, to 64 bp. The risk premia of Turkey, Croatia and Poland also went down, while those of Hungary and Romania edged up. After that, the risk premia of all countries observed stayed almost unchanged in October. With the exception of Turkey, all countries in the region had lower risk premia compared to both EMBI Global Composite and EMBI Europe. On 18 September, Serbia's risk premium, measured by EMBI, hit its lowest value on record (49 bp), staying thereafter among the lowest in the region, and providing yet another confirmation of investors' confidence in our favourable macroeconomic prospects and their greater readiness to invest in Serbia.

The improvement in Serbia's credit rating also sends a positive signal to investors. After Moody's upgraded Serbia's outlook from "stable" to "positive" and affirmed its credit rating at Ba3 in early September, Fitch increased Serbia's credit rating from BB to BB+ by the end of the same month, bringing Serbia for the first time only a step away from investment grade. The credit rating upgrade reflects the preserved price stability and fiscal discipline,

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

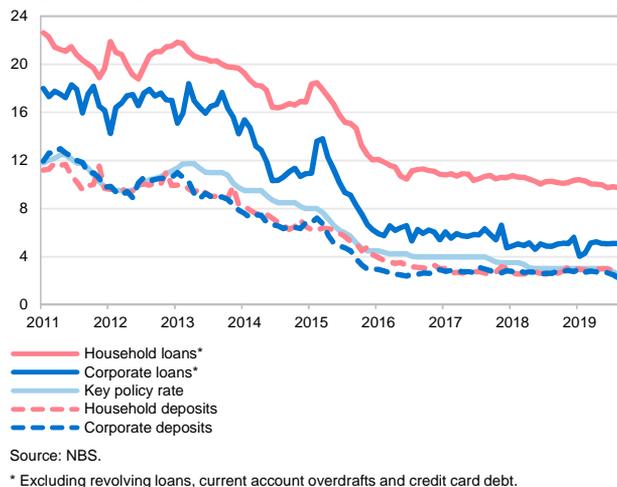


Chart IV.1.7 Interest rates on new euro and euro-indexed loans and deposits (weighted average values, p.a., in %)

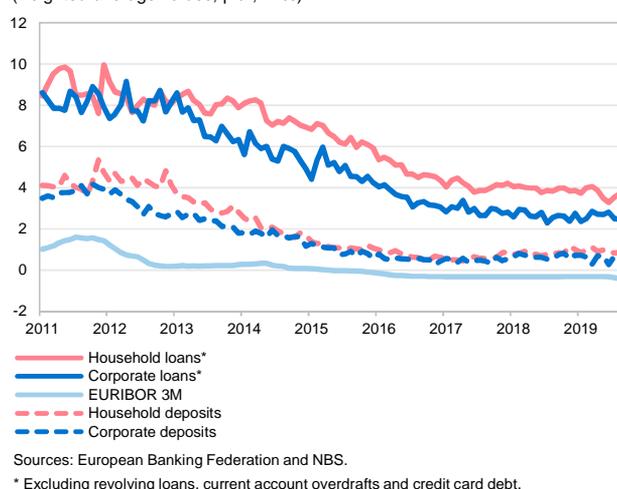


Chart IV.1.8 Risk premium indicator – EMBI by country (daily data, in bp)

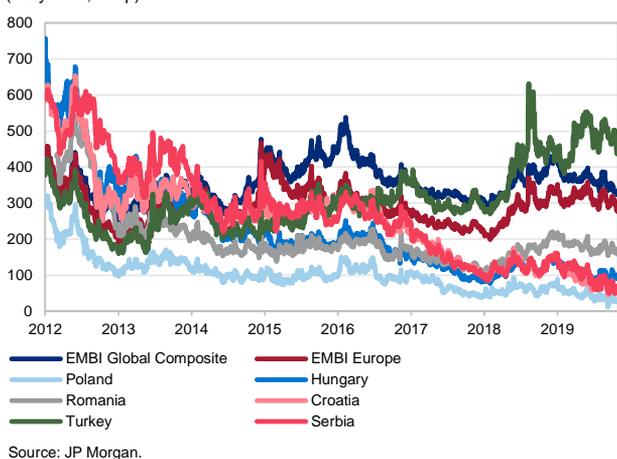
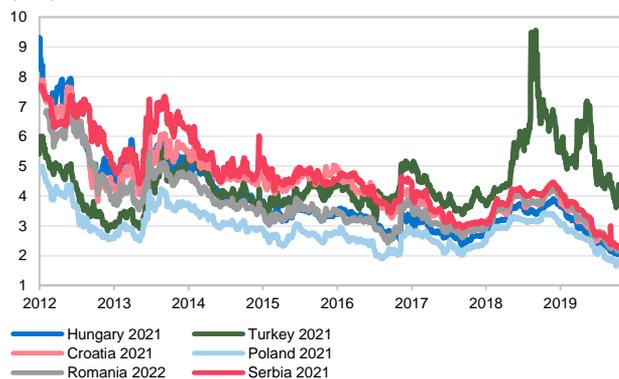


Chart IV.1.9 Yields on eurobonds of countries in the region (in %)



Source: Bloomberg.

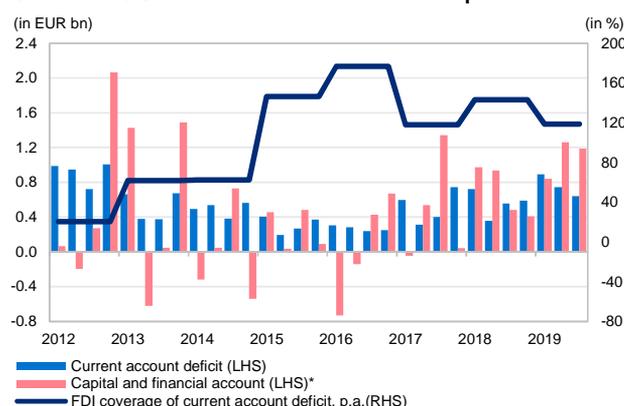
Table IV.1.1 Credit rating (change of rating and outlook)

	2016	2017	2018	2019
S&P	BB-/stable <sup>1)</sup> /positive <sup>5)</sup>	BB/stable <sup>5)</sup>	BB/positive <sup>5)</sup>	
Fitch	BB-/stable <sup>3)</sup>	BB/stable <sup>5)</sup>		BB+/stable <sup>4)</sup>
Moody's	B1/positive <sup>2)</sup>	Ba3/stable <sup>2)</sup>		Ba3/positive <sup>4)</sup>

Source: NBS.

<sup>1)</sup>January, <sup>2)</sup>March, <sup>3)</sup>June, <sup>4)</sup>September, <sup>5)</sup>December.

Chart IV.1.10 Current account deficit and net capital inflow

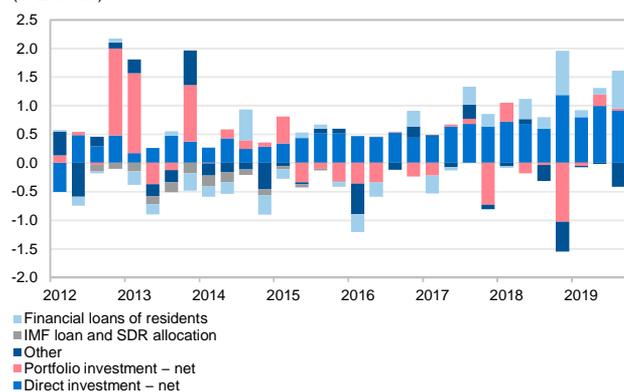


Source: NBS.

Note: Preliminary data for Q3 2019.

\* Excluding changes in NBS FX reserves.

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



Source: NBS.

Note: Preliminary data for Q3 2019.

continuous strengthening of the banking sector and improvement of the business environment. Also, the Agency expects economic growth to continue to be investment- and exports-driven which, according to them, should result from the commitment of Serbian authorities to the continuity of the economic policy.

## Foreign capital inflow

The relatively high capital inflow was sustained in Q3, which, together with more favourable foreign trade trends relative to H1, added to appreciation pressures on the dinar. Like before, most of the inflow was FDI, which exceeded the current account deficit by a significant amount. Inflows were also registered on account of higher foreign borrowing by banks and corporates, and foreign investors' purchase of government dinar securities.

FDI in Serbia continued to grow in Q3, reaching (according to preliminary data) EUR 911.5 mn net. Thus, FDI inflow in the first nine months of 2019 came at EUR 2.9 bn, almost 33% higher than in the same period a year earlier. FDI was highly diversified by project and geography, and most of it in H1, as before, was channelled to manufacturing (35%), construction (20%), financial sector (12%) and transport (8%). Around 89% of FDI came from European countries, of which around 60% from the EU, while investment from Asian countries accounted for around 8% of total FDI inflow.

Net capital inflow was registered also on account of **portfolio investment** (EUR 44.8 mn), thanks primarily to the purchase of government securities in the domestic market by foreign investors (EUR 102.5 mn)<sup>3</sup> which stepped up even though the government held fewer auctions of dinar securities than in H1 due to reduced financing needs. In addition to readiness to accept lower yields in conditions of the ongoing monetary accommodation by leading central banks, increased investment in government dinar securities reflects the fact that Serbia has become an attractive investment destination owing to the achieved and maintained macroeconomic stability, which has been also confirmed by a credit rating upgrade.

In Q3, resident liabilities under **financial loans** went up by EUR 653.8 mn net, driven mainly by banks (up by EUR 458.1 mn), i.e. their predominantly short-term borrowing. Foreign liabilities of corporates also increased – by EUR 211.1 mn net, while those of the government

<sup>3</sup> Increased residents' investment abroad worked in the opposite direction.

and the NBS decreased by EUR 11.2 mn and EUR 4.2 mn net, respectively.

### Trends in the FX market and exchange rate

Appreciation pressures continued into Q3 and persisted throughout October. In the period July–October, the dinar gained 0.3% against the euro, while losing 1.4% against the dollar due to the dollar’s strengthening vis-à-vis the euro.

Like before, the demand for foreign exchange in the domestic FX market was by far outstripped by supply, reflecting, inter alia, more favourable balance of payments trends – a smaller foreign trade deficit, sustained FDI growth and increased non-resident investment in government dinar securities, most notably in July. The strengthening of the dinar was also supported by the high purchase of foreign cash, due in part to the inflow of remittances, as well as by the increase in non-resident card payments in Serbia, typical of the summer months. The rise in FX-indexed lending, i.e. increase in FX-indexed bank assets<sup>4</sup>, worked in the same direction, particularly in the course of August and September.

To ease excessive short-term volatility of the dinar against the euro, in Q3 and in October the NBS intervened in the IFEM mostly on the purchase side, buying a total amount of EUR 1,505.0 mn, whereas on the sale side it intervened with a total of EUR 120.0 mn.

The daily trading volume in the IFEM<sup>5</sup> averaged EUR 21.3 mn in Q3, down by EUR 1.4 mn from Q2. The highest trading volume was registered in August (on average EUR 28.1 mn a day).

In Q3 the NBS organised regular FX swap auctions (no additional swap auctions we held), with the registered trading volumes lower than a quarter earlier. This is mainly due to the lower volumes in the two-week auctions where the NBS bought/sold from/to banks EUR 62.0 mn each (EUR 32.0 mn less than in Q2), while in the three-month auctions it bought/sold EUR 15.0 mn each (EUR 3.0 mn less than in Q2).

In contrast to the dinar, other currencies of regional peers running similar exchange rate regimes weakened – Hungarian forint by 3.3%, Polish zloty by 2.8%, Czech koruna by 1.4% and Romanian leu by 0.3%. In addition

<sup>4</sup> Aiming to balance their open long FX position and thus reduce the exposure to FX risk, banks sell foreign currency, which leads to the strengthening of the dinar.  
<sup>5</sup> Excluding the NBS.

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

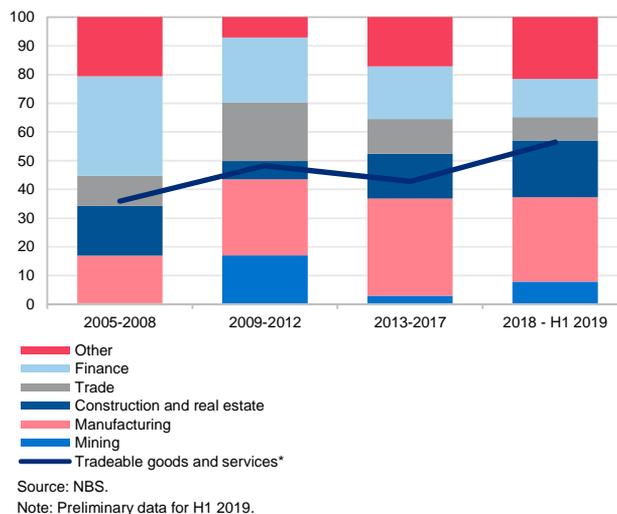


Chart IV.1.13 Movements in USD/RSD and USD/EUR exchange rates



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

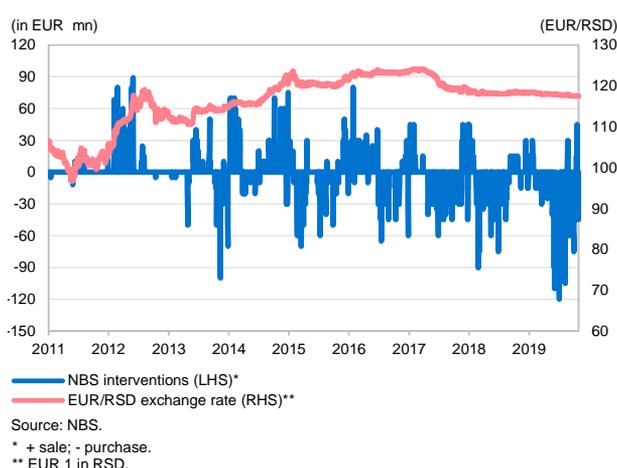
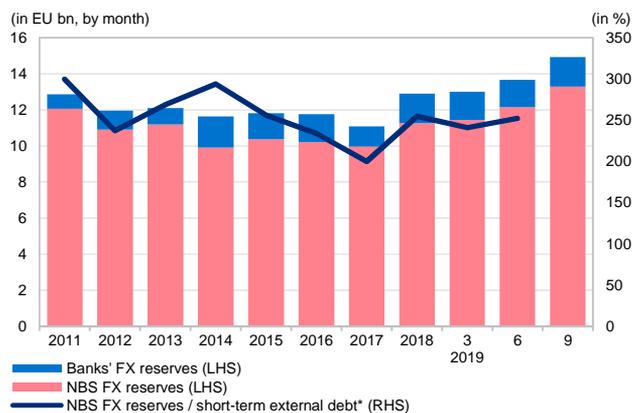


Chart IV.1.15 FX reserves and coverage of short-term external debt

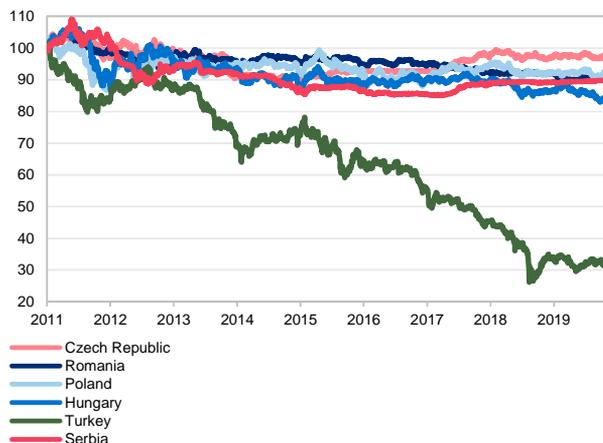


Source: NBS.

\* Short-term debt by remaining maturity.

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.

to specific domestic factors, the weakening of these currencies can be put down to the slackening economic activity in the euro area, heightened trade tensions and uncertainties surrounding Brexit. At the same time, the yields on Turkish securities stayed quite high despite policy rate cuts, which in conditions of monetary accommodation by leading central banks helped the Turkish lira strengthen by 6.0%.

## 2 Money and loans

*Led by the corporate loan growth, lending accelerated to 10.4% y-o-y in September, excluding the exchange rate effect. Hand in hand with the vibrant economic activity, lending continued to provide a positive contribution to the growth in monetary aggregates. The rise in government deposits in the banking system worked in the opposite direction, thanks to the fiscal surplus in the year to date.*

### Monetary aggregates

The broadest monetary aggregate, M3, recorded 3.5% growth in Q3, two thirds of which originated from the rising dinar component. The greatest positive contribution came from **transaction deposits**, which gained RSD 50.5 bn in Q3. Corporate transaction deposits increased by RSD 41.0 bn, which can be associated with the economic acceleration in Q3. The rise in household transaction deposits (by RSD 11.6 bn) resulted primarily from positive trends in the labour market. Other sectors' account balances remained almost unchanged from end-Q2.

**Time dinar deposits** of non-monetary sectors increased by RSD 7.7 bn in Q3. Save for public enterprises, all sectors increased their time dinar deposits, testifying to the growing confidence in the domestic currency. Household accounts recorded the strongest increase, whereby the dynamic growth of dinar savings in 2018 (22.2%) extended into 2019. In the nine months of 2019, household dinar savings increased by RSD 13.0 bn, to RSD 73.5 bn in September, posting higher growth than in the whole of 2018. This growth extended into October, when dinar savings, according to preliminary data, reached the new record level of close to RSD 75 bn. The growing confidence in the domestic currency came as a result of the preserved price stability and relative stability of the exchange rate, to which the NBS provided the key contribution. Dinar savings are more attractive than FX savings thanks to higher interest rates and more favourable tax treatment.

Table IV.2.1 Monetary aggregates

(nominal y-o-y rates, in %)

	2018		2019		Share in M3 Sept. 2019 (in %)
	Dec.	March	June	Sept.	
M3	14.5	14.8	11.2	13.1	100.0
FX deposits	13.2	13.9	8.6	9.4	59.5
M2	16.7	16.2	15.4	19.2	40.5
Time and savings dinar deposits	11.4	15.9	15.2	18.6	9.8
M1	18.3	16.4	15.5	19.3	30.7
Demand deposits	20.6	16.1	15.1	22.1	23.6
Currency in circulation	11.4	17.3	17.0	11.0	7.0

Source: NBS.

The share of dinar in total deposits is on the rise, both in the corporate and household segment. At end-Q3, the **degree of dinarisation** measured 56.9% for corporate deposits, rising by 1.9 pp from Q2, while in the household segment it reached the maximum of 20.6% (up by 0.6 pp from Q2).

In Q3, **FX deposits** increased by EUR 284.8 mn, mainly owing to the rise in FX savings of households which in September reached their new maximum of EUR 10.3 bn.<sup>6</sup> Since the start of the year FX savings of households went up by EUR 633.3 mn (rising almost evenly in quarterly terms). Apart from that, corporate FX deposits increased by EUR 57.3 mn in Q3, thanks to FX inflows on account of exports, FDI and corporate borrowing abroad.

In y-o-y terms, M1, M2 and M3 sped up their growth to 19.3%, 19.2% and 13.1% respectively in September, receiving the greatest positive contribution from credit activity, while the rise in government deposits in the banking system worked in the opposite direction, thanks to the fiscal surplus.

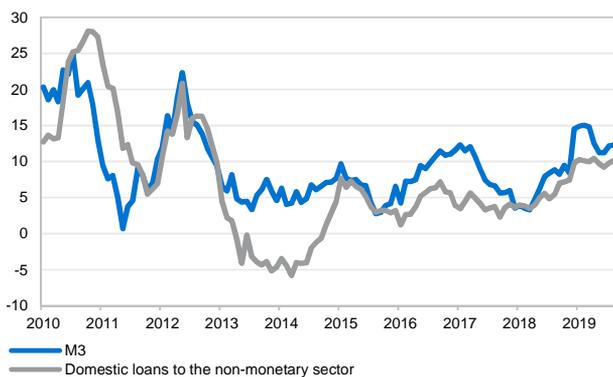
### Loans

Excluding the exchange rate effect, total domestic loans accelerated their y-o-y growth to 10.4% in September (from 9.4% at end-Q2), driven by the rise in corporate and household loans. The acceleration of corporate loan growth (to 11.6% in September) is a result of increased investment lending, while slightly slower growth in household loans (9.3% in September) can be put down to the slowdown in cash loans.

In the year to date, excluding the exchange rate effect, corporate loans gained RSD 68.1 bn,<sup>7</sup> driven almost fully by the growth of company loans. Thanks to high corporate demand for investment loans (relative to end-2018 they increased by RSD 77.6 bn), the share of this category in total corporate loans expanded to 43.6% in September.<sup>8</sup> Next in size were loans intended for current assets financing, accounting for 39.8%, and non-categorized loans – 11.1% of total corporate loans. Sector-wise, the strongest credit growth was recorded in construction, trade, transport and real estate.

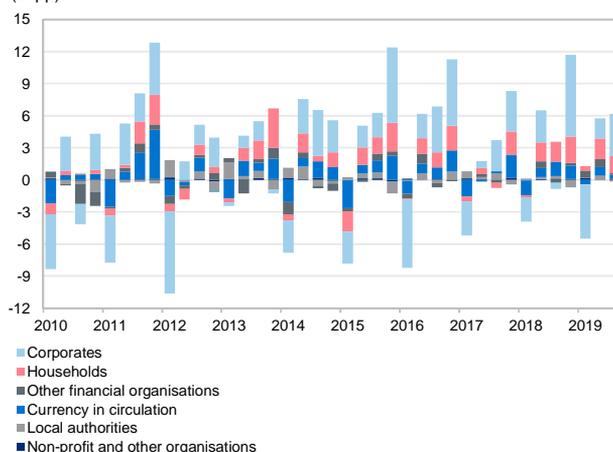
The stock of **new corporate loans** in Q3 (RSD 291.3 bn) increased by 13.3%, excluding the loans refinanced with

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



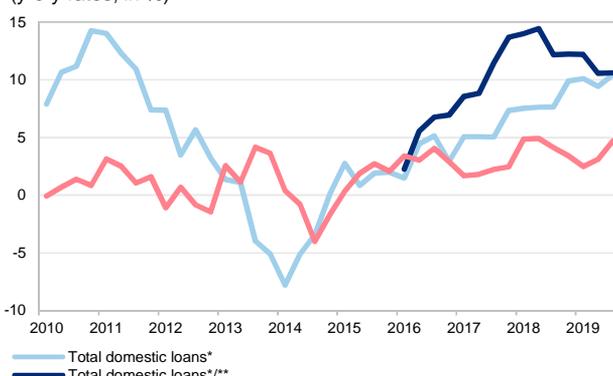
Source: NBS.

Chart IV.2.2 Contributions to quarterly 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.

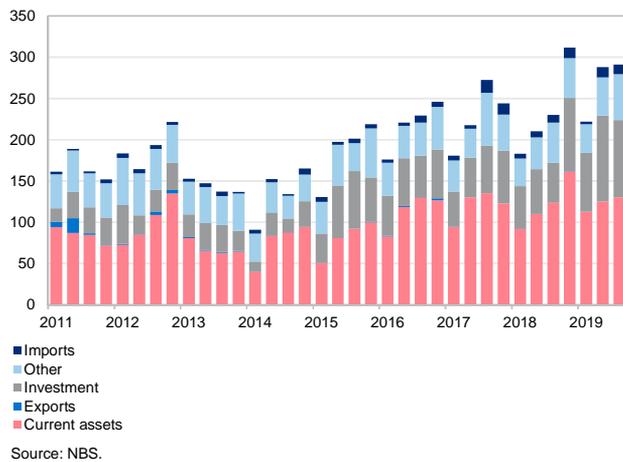
\*\*\* NBS estimate for Q3 2019.

<sup>6</sup> Money supply M3 includes only resident funds. With non-resident funds included, at end-September dinar savings equalled RSD 74.1 bn and FX savings EUR 10.6 bn.

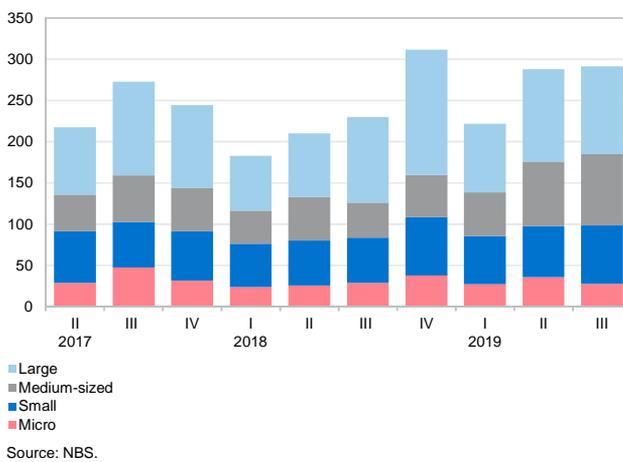
<sup>7</sup> Almost two thirds of this growth referred to Q3.

<sup>8</sup> Since May, this was the most prominent category of corporate loans.

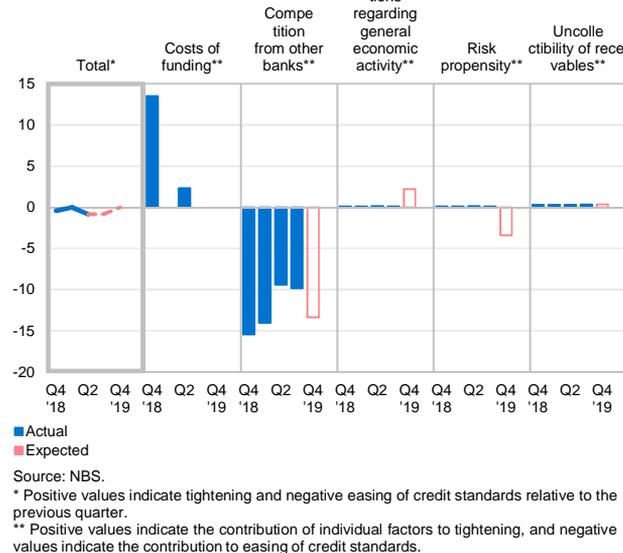
**Chart IV.2.4 Structure of new corporate loans, by purpose**  
(in RSD bn)



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



**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)



the same bank. The majority referred to current assets loans, which made up 44.7% of total approved corporate loans in Q3, and two thirds of which were taken up by the market segment of micro, small and medium enterprises. The continuation of corporate investment activity is also reflected in high disbursement of investment loans – RSD 93.5 bn in Q3, which is, excluding the loans refinanced with the same bank, an increase by over 63% from the same period the year before.

According to the **NBS Bank Lending Survey in October**,<sup>9</sup> corporate credit standards were eased in Q3, consistent with the expectations stated in the July survey. The key contributing factors, according to banks, were the competition in the banking sector and lower costs of dinar sources of funding owing to the NBS’s monetary policy easing. Banks do not expect a change in standards in Q4, but anticipate that competition and higher risk appetite will work toward standards easing. They assess that corporate loan demand is on the rise, primarily in the segment of small and medium-sized enterprises. Financing of capital investment and current assets are the biggest drivers of the growth in demand, which is expected to rise further in Q4.

Excluding the exchange rate effect, **household loans** increased by RSD 71.0 bn since the start of the year. The most prominent categories of household loans are cash and housing loans, accounting for 42.3% and 36.4% in September, respectively. In the first nine months of 2019 cash loans went up by RSD 47.9 bn, or RSD 3.9 bn less than in the same period last year. The share of cash loans with maturities of over eight years has also been on decline, which indicates that the NBS’s measures aimed at curbing non-purpose lending to households at unreasonably long maturities adopted in December 2018 are yielding results. In the first nine months of 2019, housing loans increased by RSD 11.2 bn.<sup>10</sup>

**The volume of new household loans** in Q3 2019 (RSD 130.8 bn) increased by 10.5% y-o-y, or by 7.9% excluding the loans refinanced with the same bank. The major portion were cash loans (58.7%), more than 99% of which were in dinars. The amount of new cash loans in the first nine months of this year edged down by 1.4% compared to the same period last year, while the amount of housing loans, excluding the loans refinanced with the same bank, increased by 21.8%, as a result of the

<sup>9</sup> The NBS implements the survey since the start of 2014.

<sup>10</sup> Despite the fact that according to the Law on Conversion of Housing Loans Indexed to Swiss Francs, 38% of the value of these loans was written off through conversion.

recovery of the real estate market and positive movements in the labour market.

The results of the **October Lending Survey** show that, in banks' view, competition in the sector, lower cost of financing, positive expectations regarding the economic situation and higher risk appetite in Q3 led to the easing of household credit standards. Further mild relaxation is expected in Q4, with the positive contribution of almost all factors. Banks point out that Q3 saw an increase in household loan demand, driven by real estate purchases and positive developments in the real estate market, as well as by the refinancing of current liabilities. They anticipate further growth in household loan demand in Q4 as well.

**The share of dinar loans in total corporate and household loans at end-September** reached 33.3%, slightly increasing relative to end-Q2. Dinarisation of household receivables continued up, reaching its new maximum of 55.4% at end-Q3, while dinarisation of corporate receivables declined mildly, to 14.1% (due to the faster growth of FX-indexed and FX loans).

Successful implementation of measures envisaged by the NPL Resolution Strategy, against the background of vibrant economic and credit activity, helped to bring down the **gross NPL ratio** to the lowest level since this indicator of asset quality is monitored – 4.7% in September.<sup>11</sup> From the beginning of 2019, NPL share in total loans decreased by 1.0 pp, with the corporate NPL ratio going down by 1.4 pp to 3.7%<sup>12</sup>, and the household one by 0.3 pp to 4.1%.<sup>13</sup> Further balance sheet cleansing of banks helped to push NPLs below EUR 1.0 bn and in the first nine months of 2019 banks wrote off RSD 11.9 bn and sold to non-bank entities RSD 5.7 bn worth of NPLs directly from their balance sheets.<sup>14</sup> NPL coverage remained high – allowances for impairment of total loans measured 80.3% of NPLs in September, while allowances for impairment of NPLs stood at 60.1% of NPLs. Also, after the introduction of Basel III standard,<sup>15</sup> capital adequacy ratio rose further, to 23.6% at end-Q3 2019, indicating high capitalisation of the domestic banking sector.

<sup>11</sup> Relative to July 2015, i.e. the period just before the Strategy adoption, this indicator declined by 17.7 pp, while the NPL stock contracted by RSD 317.3 bn (73.8%).

<sup>12</sup> Includes companies and public enterprises. Looking only at companies, the share of NPLs in total loans came at 3.8% in September, down by 1.4 pp from December 2018.

<sup>13</sup> Including entrepreneurs and private households, the share fell by 0.3 pp to 4.1%.

<sup>14</sup> From the beginning of 2016 banks wrote off RSD 194.3 bn worth of NPLs, and sold RSD 94.5 bn of NPLs, which were in their balance sheets at the time.

<sup>15</sup> The regulatory Basel III framework is applied as of 30 June 2017.

Chart IV.2.7 Structure of new household loans

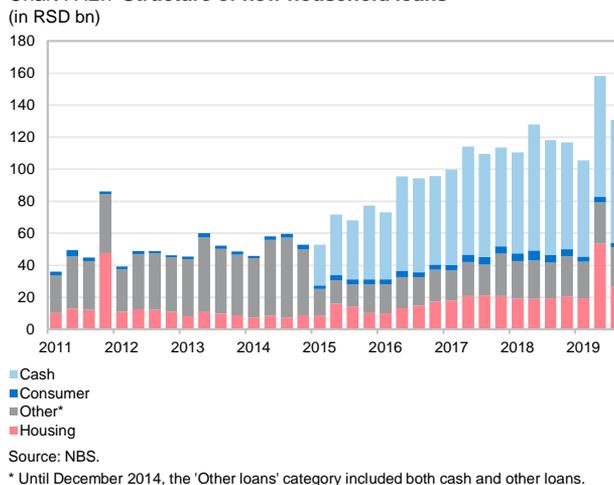


Chart IV.2.8 Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to households

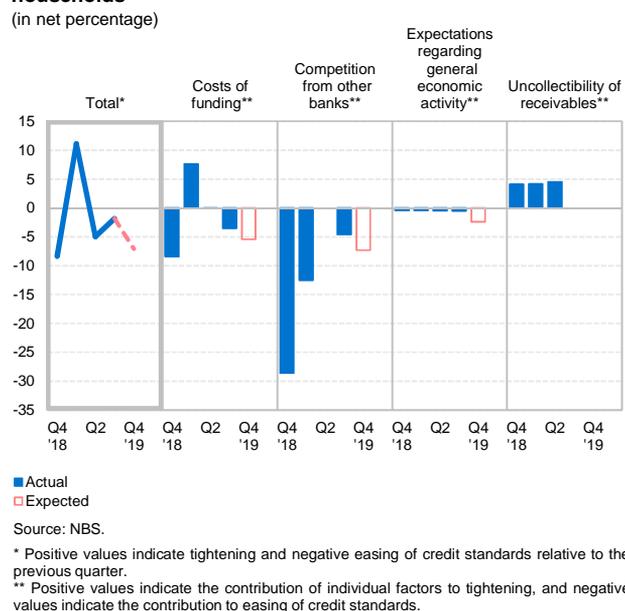
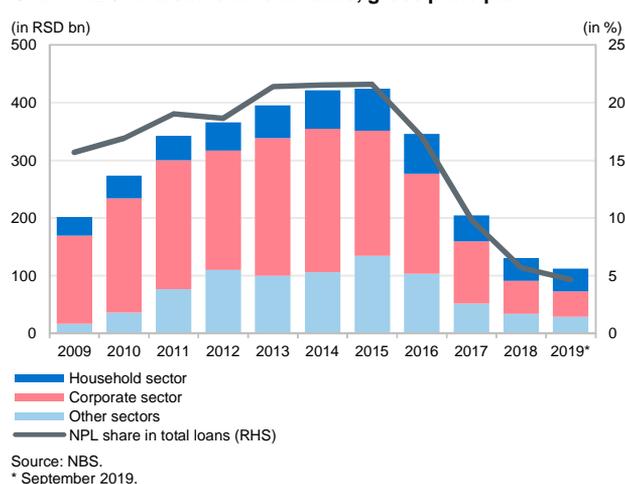


Chart IV.2.9 NPL share in total loans, gross principle



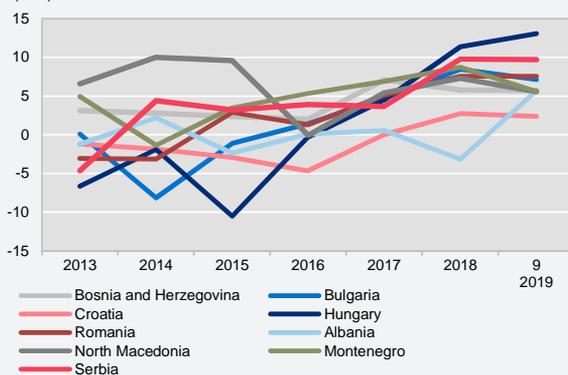
### Text box 1: Current trends in lending

Domestic lending has been recovering since early 2015 and recording, for some time already, relatively high y-o-y growth rates, which in 2019 were mainly two-digit. In September, excluding the exchange rate effect, y-o-y growth in domestic loans equalled 10.4% (9.7% nominally) and was among the highest in the region. In addition, since the start of H2, the growth has been supported by lending to corporates to a higher extent than to households (6.0 pp vs. 4.3 pp in September). Lending recovery in the period observed was aided by both supply- and demand-side factors. In the past and this year, a stronger impetus came from demand-side factors, notably in the corporate sector, owing to positive macroeconomic prospects and acceleration of economic growth. Another important contributor to the recovery of lending in the period reviewed were favourable conditions of financing the private sector given that the interest rates on dinar and euro-indexed loans were lowered multiple times in the prior period owing to monetary policy easing by the NBS and ECB and a falling risk premium. At the same time, there is a feedback loop between lending and economic activity, which is why loans represent an important pillar of sustainable economic growth, as seen in their favourable growth structure, i.e. the fact that investment loans account for the bulk of corporate loans.

Since mid-2017, corporate loans have been recording positive growth rates, and excluding the effect of the write-off and sale of NPLs (which in the period of intensive activity of banks to cleanse their balance sheets from toxic assets, notably during 2016 and 2017, significantly lowered the accounting stock of loan receivables<sup>1</sup>), they have been two-digit since Q4 2017. Current trends in corporate lending, along with y-o-y lending growth of 11.6% in September, suggest that lending significantly supports investment growth. Y-o-y growth in investment loans has been positive since 2015 and on a constant rise. In September it reached 27.4% and the share of these loans in total corporate loans stood at 43.6%. Since May, these loans have been the most prevalent category of corporate loans, followed by liquidity and current assets loans, whose share equalled 39.8% in September. Stepped-up investment lending contributes to the lengthening of the average maturity of corporate loans, which in September equalled around 4.7 years. In terms of activity, growth in investment

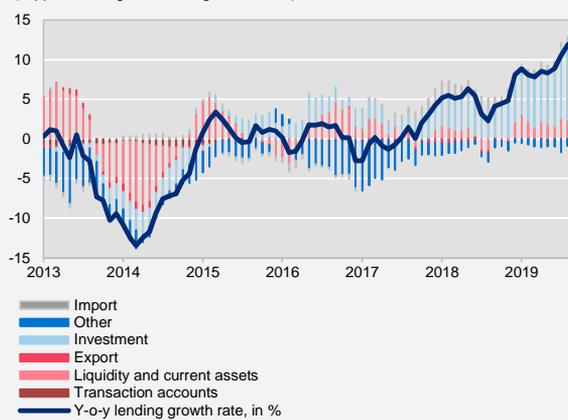
lending was led primarily by lending to enterprises in the fields of manufacturing, construction (including real estate), transport and tourism. In terms of enterprise size, three fourths of total investment loans were extended to micro, small and medium-sized enterprises. Over the past months, large enterprises have also occasionally contributed to this growth. In contrast to investment loans, y-o-y growth in current assets loans has been lower, suggesting that in an environment of improved liquidity and profitability, the corporate sector taps credit sources primarily to finance investment and durable current assets. In terms of activity, current assets loans are used predominantly by enterprises in the fields of trade and manufacturing, whose obligations accounted for two thirds of loans approved for these purposes. In terms of

Chart O.1.1 Nominal y-o-y lending growth rates (in %)



Sources: Websites of central banks and NBS calculation.

Chart O.1.2 Contributions to y-o-y corporate lending growth (in pp, excluding the exchange rate effect)



Source: NBS.

<sup>1</sup> From early 2016 to end-2018, banks wrote off RSD 135.6 bn and sold RSD 86.7 bn-worth of corporate NPLs on their balance sheets at the moment of sale. The write-off and sale continued in 2019, but given the results achieved in this area, in significantly smaller amounts – in the course of nine months, corporate NPLs worth RSD 7.9 bn were written off and RSD 5.4 bn sold.

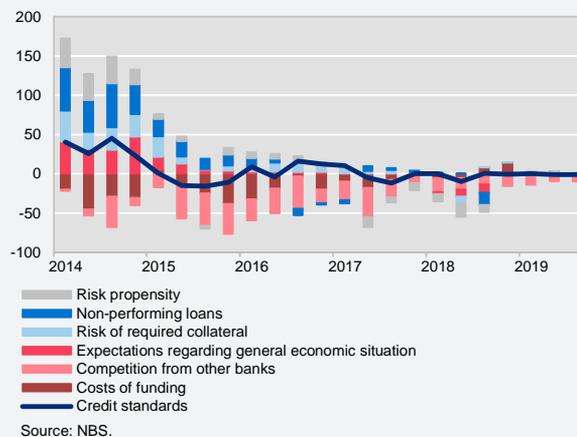
enterprise size, large enterprises are using these loans less than before, unlike small and medium-sized enterprises, where this borrowing is on a rise.

As a result, there is a tendency of equalizing the shares of small and medium-sized enterprises (28% each in September) and large enterprises (around 31% in September) in current assets loans. The growth in corporate loans stems from lending to companies, while the contribution of lending to public enterprises is significantly smaller (it was even negative from 2016 until slightly before end-2018), reflecting the Government’s decision not to issue guarantees for liquidity loans to public enterprises. As a consequence, loans to public enterprises are currently making up around 9% of total corporate loans, by around 7 pp less than four years ago.

Palpable recovery of corporate lending coincided with the easing of banks’ corporate credit standards, which, according to the NBS bank lending survey, has been present since Q2 2017. This was aided by banking sector competition and the efforts to attract quality clients, including greater risk propensity in an improved macroeconomic and business environment in the country. This is also supported by the results concerning the impact of NPLs on credit standards which in the period before the adoption of the NPL Resolution Strategy were recognised as a factor behind their tightening. In addition to the reduction in the share of gross NPLs in total loans by almost 18 pp (to the minimum of 4.7% in September), the success of the Strategy and banks’ efforts to resolve the NPL issue is also reflected in a changed perception of banks, and a changed direction of the impact of this factor on the easing of credit standards. Besides, favourable financing conditions contributed to bank’s improved loan supply, with a strong impetus coming from NBS monetary policy easing, along with a vigorous fall in the country risk premium and monetary accommodation by the ECB. Thus, since May 2013, when the NBS began to ease monetary policy, the rates on dinar corporate loans fell by 12.0 pp to 4.4% in September, and the rates on euro-indexed and euro loans dropped by 4.7 pp to 2.6%. According to the survey results, corporate loan demand was assessed as rising. Banks recognised small and medium-sized enterprises as the drivers of growth of corporate loan demand, and the need to finance capital investment and current assets as the key factors contributing to the trend, which is consistent with the results achieved, i.e. growth in investment loans.

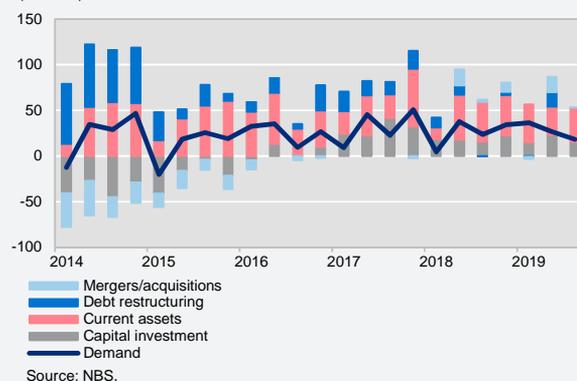
Household loans, which supported the rise in domestic loans all the time after the global economic crisis, picked up at a faster pace since 2016 in y-o-y terms, owing primarily to the high disbursement of cash loans. In time, a more significant

Chart O.1.3 Change in corporate credit standards and ontributing factors (in net %)



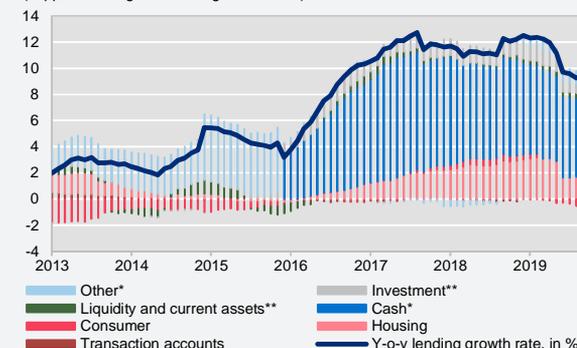
Source: NBS.

Chart O.1.4 Corporate loan demand and contributing factors (in net %)



Source: NBS.

Chart O.1.5 Contributions to y-o-y household lending growth (in pp, excluding the exchange rate effect)



Source: NBS.

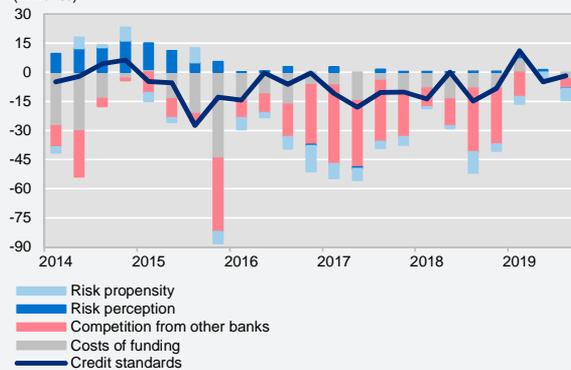
\* Until December 2015, the contribution of cash loans is shown within the contribuc of other loans.  
 \*\* Loans extended to entrepreneurs.

contribution started coming from housing loans, which have been rapidly recovering since early 2017, propped up by economic growth and favourable labour market trends. However, since the start of 2019, y-o-y growth in household loans has slowed. In September it equalled 9.3%, reflecting lesser disbursement of cash loans and, temporarily from May to July, the write-off of a part of principal amid conversion of CHF-indexed housing loans into euro-indexed loans. Over the past year, y-o-y growth in cash loans has been slowing, equalling 15.0% in September, with the tendency of shortening the maturity up to eight years, on account of measures aimed at limiting unsecured non-purpose lending to households at unreasonably long maturities, adopted by the NBS in late 2018.<sup>2</sup> On the other hand, the recovery of housing loans continued, as evidenced by the amount of new housing loans, which, excluding the effect of loans refinanced with the same bank, was higher by close to 22% in the nine months of this year compared to the same period of 2018.

According to the results of the bank lending survey, supply-side factors provided a stronger impetus to household lending – banks began to ease standards in 2015, two years earlier than in the case of the corporate sector. The easing of standards was under the strongest impact of interbank competition, while the improvement of the macroeconomic environment and a rise in the living standard contributed to banks' greater risk propensity. Lower costs of lending sources, along with falling interest margins, led to a drop in the rates on household loans – by 11.0 pp to 9.6% on dinar loans and by 4.3 pp to 3.8% on euro-indexed loans from May 2013 to September 2019. The need to purchase real estate and refinance current liabilities gave a key contribution to rising household loan demand, directed primarily at dinar cash and refinancing loans, and FX-indexed housing loans.

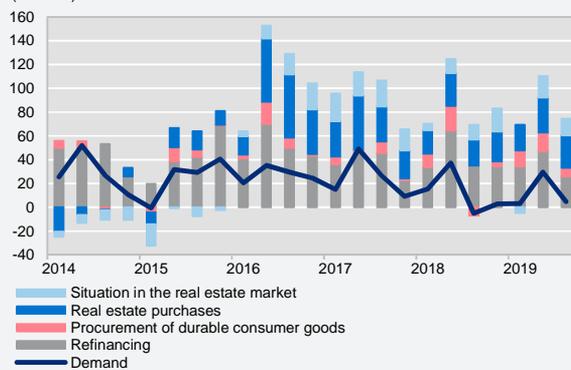
Although lending activity has accelerated, the share of domestic loans in GDP is not exceeding 45%. Including external debt of enterprises, it stands at 75.3%,<sup>3</sup> which is still below the long-term trend, posing no risk to financial and price stability, which suggests ample room for vibrant lending growth to continue. We expect this growth to carry on in the coming period, thanks to past monetary policy easing by the NBS, sustainable economic growth, low euro area interest rates, rising employment, wages and pensions, and the progress in resolving NPLs.

Chart O.1.6 Change in household credit standards and contributing factors (in net %)



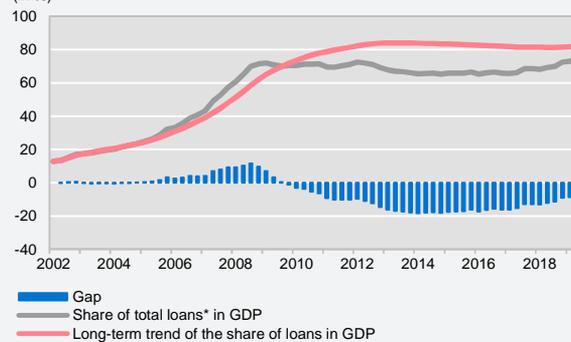
Source: NBS.

Chart O.1.7 Household loan demand and contributing factors (in net %)



Source: NBS.

Chart O.1.8 Share of total loans in GDP and estimate of long-term trend (in %)



Sources: NBS and SORS.

\* Including cross-border corporate borrowing.

<sup>2</sup> The Decision on Managing Concentration Risk Arising from Bank Exposure to Specific Products, and amendments and supplements to the Decision on Capital Adequacy of Banks and the Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items.

<sup>3</sup> According to the methodology for establishing the countercyclical capital buffer rate, as at Q2 2019.

### 3 Aggregate demand

Owing to the continuation of positive trends in the labour market, according to our estimates, in Q3 stable private consumption growth was maintained and the y-o-y investment growth was stepped up significantly. Faster GDP growth in Q3 (4.7% y-o-y) resulted primarily from a reduced negative contribution of net exports due to the acceleration of manufacturing exports led by the activation of new production capacities.

#### Domestic demand

Stable **household consumption** growth, which began in 2016 and sped up as of 2018 to over 3% y-o-y, continued in Q3, when, according to our estimate, it reached 3.3% y-o-y (contributing 2.3 pp to GDP growth). This is also confirmed by trade and tourism indicators, i.e. rising retail trade and the number of domestic tourists, including imports of consumer goods which slowed slightly compared to Q2.

Similarly to previous quarters, household consumption grew mainly owing to positive labour market trends, reflected in rising employment and wages. This is also confirmed by the real wage bill in the private sector, which has been recording two-digit y-o-y growth rates since the start of the year. Rising public sector wages also boosted consumption, though to a somewhat lesser extent (7.8% y-o-y in July–August). Remittances also recorded a mild increase in Q3 (2.9% y-o-y). At the same time, the growth in loans intended for consumption continued to slow down.

According to our estimate, Q3 saw acceleration in **government spending** to 3.0% y-o-y, with a 0.5 pp contribution to GDP growth. The real rise in expenditure for the purchase of goods and services increased by 15.8% y-o-y in Q3 and expenditure for employees by 8.3% y-o-y.

In quarterly terms, we estimate that the pace of consumption growth recorded in Q2 continued into Q3 (0.8% s-a, contributing 0.7 pp to GDP growth).

Continuous improvement in the investment environment, as evidenced by Serbia's further progress on the Doing Business list by four notches, to the 44<sup>th</sup> place out of 190 countries, including favourable terms of investment financing, contributed to an increase in **private investment** which, according to our estimate, grew by 11.0% y-o-y in Q3 (adding 1.8 pp to GDP growth). Such movements are suggested primarily by the 17.5% y-o-y

Chart IV.3.1 Contributions to y-o-y GDP growth rate – expenditure side

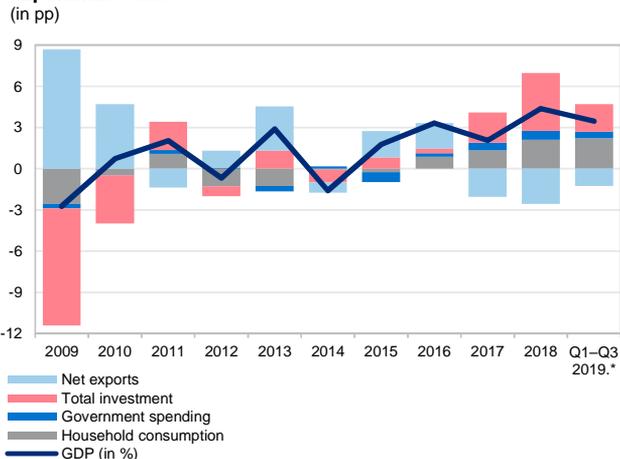


Table IV.3.1 Movement in main indicators and sources of household consumption (real y-o-y growth rates, in %)

	2019		
	Q1	Q2	Q3
<b>Household consumption</b>	<b>3.3</b>	<b>3.2</b>	<b>3.3 *</b>
<b>Indicators</b>			
Retail trade	9.5	7.8	8.2
Catering turnover	10.2	8.0	9.3 **
Number of domestic tourists	3.5	7.1	7.1
Number of overnight stays of domestic tourists	1.3	7.6	5.4
Consumer goods imports (BEC classification), nominal	11.0	17.6	14.7
<b>Sources</b>			
Total wage bill, nominal	14.3	14.0	14.1 ***
Net remittances inflow, nominal	2.6	-5.3	2.9
New consumer and cash loans, nominal	18.5	15.7	13.9

Sources: SORS and NBS calculation.

\* NBS estimate.

\*\* July (SORS estimate).

\*\*\* July–August.

Chart IV.3.2 Fixed investment

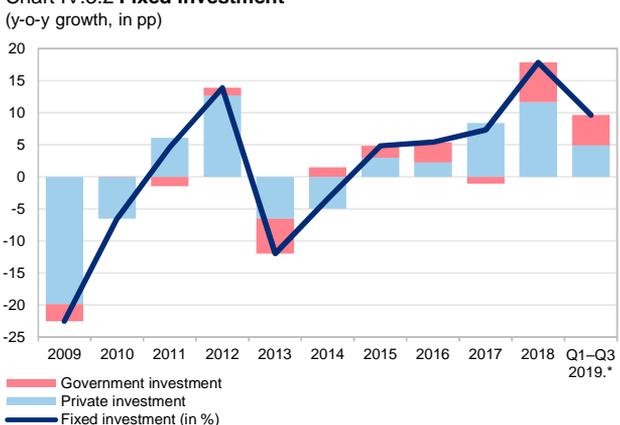


Table IV.3.2 Investment indicators

	2019		
	Q1	Q2	Q3
<b>Real y-o-y growth rates (in %)</b>			
Fixed investment (national accounts)*	7.8	8.6	12.0
Construction (national accounts)*	10.5	16.8	35.0
Government investment*	32.9	33.4	16.1
Number of construction permits issued	0.0	6.9	14.4 **
Production of construction material	10.6	-0.6	3.4
Value of works performed	13.6	18.9	-
Imports of equipment, nominal	18.2	6.8	17.5
Production of domestic machinery and equipment	16.1	-4.0	-9.0
Finished product inventories in industry	3.9	0.7	-3.2

Sources: SORS and NBS calculation.

\* NBS estimate for Q3 2019.

\*\* July–August.

rise in equipment imports in Q3. That investment is rising is also indicated by positive tendencies in the construction sector, reflected, inter alia, in the 14.4% y-o-y increase in the number of issued construction permits in the first two months of Q3.

Q3 saw the continuation of a vigorous rise in government investment which, according to our estimate, equalled 16.1% y-o-y (contributing 0.7 pp to GDP growth) and can be associated with the further implementation of infrastructure projects.

In quarterly terms, private and government investment are estimated to have risen by 3.8% and around 2% s-a, respectively, contributing together 0.7 pp to GDP growth.

The improvement of the business environment and the preserved price stability and relative stability of the exchange rate pushed up FDI further, to EUR 911.5 mn net in Q3, up by over 50% y-o-y. Q3 saw the easing of borrowing conditions in the domestic market, which contributed to a rise in investment loans, which were up by 26.6% y-o-y on average in Q3.

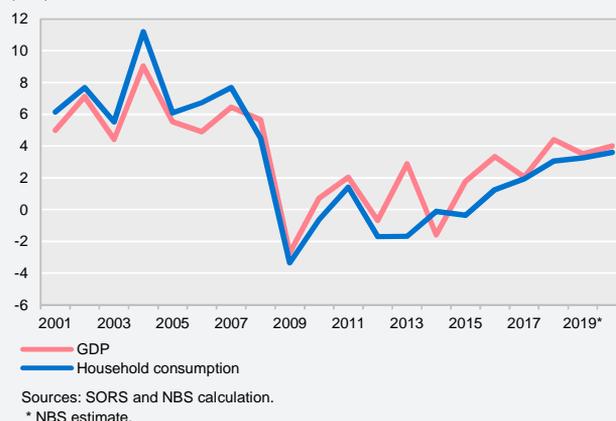
Inventories are estimated to have positively contributed to y-o-y GDP growth (0.2 pp), primarily thanks to rising inventories of agricultural products after a good agricultural season.

### Text box 2: Household consumption – trends and prospects

Household consumption has been recovering continuously since 2016 owing to positive labour market trends, i.e. rising private sector employment and wages, which reflects the improvement of the business and investment environment. Positive effects on consumption were also provided by NBS monetary policy easing, lower euro area interest rates and a falling country risk premium, which pushed up the disposable income of households on account of the lower cost of new borrowing and improved availability of loans, as well as lower costs of the repayment of outstanding loans. Consumption growth has been gradually accelerating thanks to – in addition to the rising private sector wage bill – the increase in public sector wages and pensions as of 2018. It is worth noting that the growth in household consumption remains slower than overall GDP growth. With the share of around 68%, household consumption is a dominant component of Serbia’s GDP, but its share in GDP has been falling year after year owing to a faster rise in investment and a reduction in the current account deficits. The largest share of household consumption, of as much as close to 80% of GDP, was recorded on the eve of the global economic crisis – in the period after 2001, it was rising much faster than GDP, but this growth was suddenly halted with the outbreak of the crisis. Thereafter, it began to adjust to the real economic strength of the country.

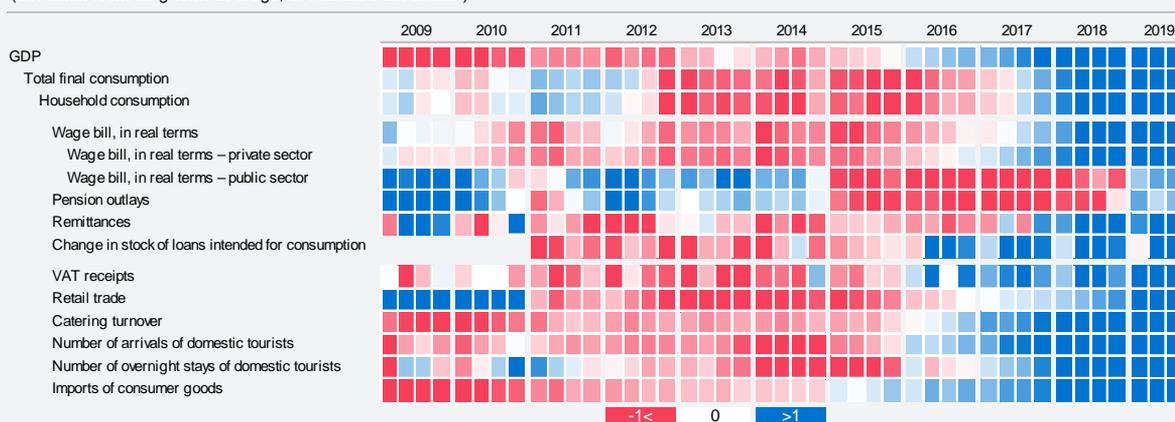
That household consumption is recovering is confirmed by almost all indicators, which have been on a continuous rise since 2016. Measured by the standard deviation, since the start of 2016, almost all consumption indicators are above the ten-year average by more than one standard deviation. Thus, the growth in retail trade of 7.3% y-o-y from 2016 continued in the following period at a somewhat slower pace, and measured 4% in 2018. VAT receipts have displayed similar dynamics – they increased by 4.3% in 2018. Tourism indicators are also rising robustly – from 2016 to 2018, the number of domestic tourists and overnight stays increased by around 10% on average per year. The rise in the living standard of households has also been accompanied with the rise in imports of consumer goods, which picked up to around 12% in 2018. Positive tendencies in the movement of the key indicators of household consumption continued into this year as well.

Chart O.2.1 Real growth in GDP and household consumption (in %)



Sources: SORS and NBS calculation.  
\* NBS estimate.

Chart O.2.2 Household consumption – indicators and sources (deviation from long-term average, in standard deviations)



Sources: SORS and NBS calculation.

According to the data from the household consumption survey, households' disposable income was RSD 64,481 on average per month in 2018, up by 9.1% compared to 2015. In the same period, the structure of household consumption changed – the shares of food, beverages and tobacco declined (from 40.2% to 39.2%), and the shares of consumption in restaurants and hotels and consumption intended for education went up – by 0.4 pp to 3.1% and by 0.3 pp to 1.5%, respectively, which is indicative of a rise in the living standard.

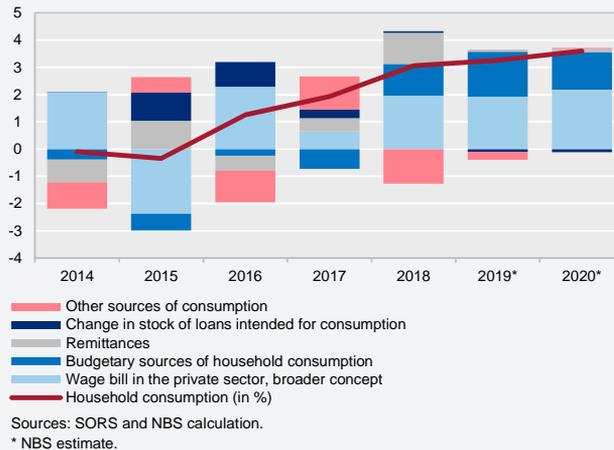
To obtain a complete picture of household consumption, one must analyse, in addition to indicators, the movement in the main sources of consumption. The primary sources of household consumption are private and public sector wages and pensions, with the share of around 75% in total sources of consumption, according to our assessments, of which the private sector wage bill (which includes the assessment of grey economy wages and employment) equals around 50%.<sup>1</sup> Household consumption growth since 2016 has been led predominantly by the rising private sector wage bill, which can be connected primarily with labour market recovery. In addition to rising formal employment, partly stemming from the reduction in informal employment, wages increased as well. Thus, in the 2016–2018 period, the private sector wage bill (including the grey economy) grew by around 3.5% on average per year. As positive labour market trends continued into 2019, given the announced increase in the minimum wage for 2020, we estimate that the growth in the private sector wage bill will accelerate to around 4% in 2019 and around 5% in 2020, creating a sound footing for a further rise in private consumption. A positive contribution should also come from rising employment, and, to a higher degree, from rising private sector wages.

In addition, after successful fiscal consolidation, as of 2018 austerity measures in the public sector have been moderated. As a result, 2018 saw real 3.6% growth in sources of household consumption originating from the budget and relating to public sector wages, pensions and other social insurance transfers. Given that the rise in public sector wages and pensions continued into this year and has been announced for the next year as well, budgetary sources of household consumption are estimated to increase at the rate of 4% in 2019 and 5% in 2020.

The secondary sources of consumption, relating to remittances inflows and household consumption loans also gave a positive contribution to rising consumption in the prior period. We expect remittances inflows to remain broadly stable, while the increase in loans intended for consumption will be somewhat lower than in 2018 due to the NBS measures concerning unsecured non-purpose lending to households at unreasonably long maturities, with a negligible negative contribution to private consumption growth.

According to our estimate, household consumption growth of around 3.3% in this and 3.6% in the next year, as already stated, will be almost fully financed from primary sources – wages, primarily in the private sector, as well as pensions, which suggests that household consumption will continue to rise at a slower pace than overall economic activity, i.e. it is sustainable and poses no risk to price stability.

Chart O.2.3 Contributions to growth in household consumption (in pp)



<sup>1</sup> The private sector wage bill includes the informally employed, according to data from labour force surveys, with an average wage, and the estimated cash supplement paid to private sector employees on top of the formal wage that is subject to taxes and contributions.

### Net external demand

As the real export growth accelerated to 10.7% y-o-y in Q3 and outpaced the real import growth (10.6% y-o-y), the negative contribution of net exports to GDP declined to 0.7 pp (from 1.5 pp in H1).

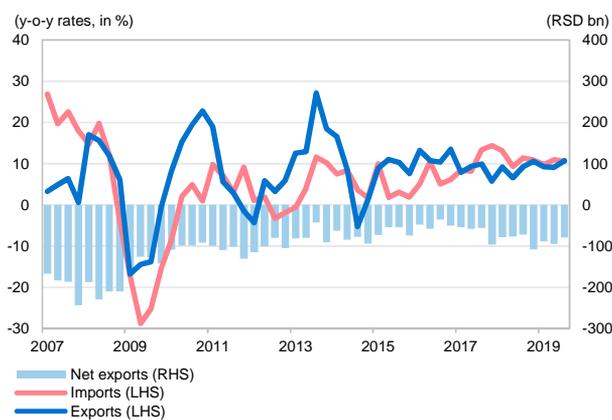
Led by manufacturing exports, along with a positive contribution of agriculture, euro goods exports were relatively high in Q3 as well (8.4% y-o-y according to balance of payments data), despite the slowdown in external demand. According to foreign trade data, manufacturing exports sped up to 8.6% y-o-y in Q3 and were broad-based (increasing in 16 out of 23 sectors). The growth was propped up primarily by a 33.1% y-o-y rise in exports of electrical equipment, with a high contribution also coming from the exports of machinery and equipment, rubber and plastic products and furniture. In addition, after the completed overhauls in the oil and chemical industry, the exports of petroleum products and chemical products resumed their customary pace as of June. Owing to high inventories built up during last year’s season, the exports of agricultural (2.3% y-o-y) and food products (11.2% y-o-y) continued up. Given this year’s solid season, this segment is expected to provide a further positive impetus to export growth.

In contrast, the exports of motor vehicles, down by 1.9% y-o-y in Q3 as the exports of “Fiat Automobiles Serbia” contracted, were almost fully compensated for by the elevated exports of other manufacturers in the car industry (1.8% y-o-y), whose share in total exports in the nine months of 2019 came at 11.7%. The exports of base metals also declined, chiefly on account of dented steel exports to the EU due to quotas, although partly compensated for by higher copper exports.

According to balance of payments data, services exports accelerated to 18.4% y-o-y in Q3, driven by business (34.5% y-o-y) and information-communication services (19.0% y-o-y). The exports of transport, tourist and other services also continued up.

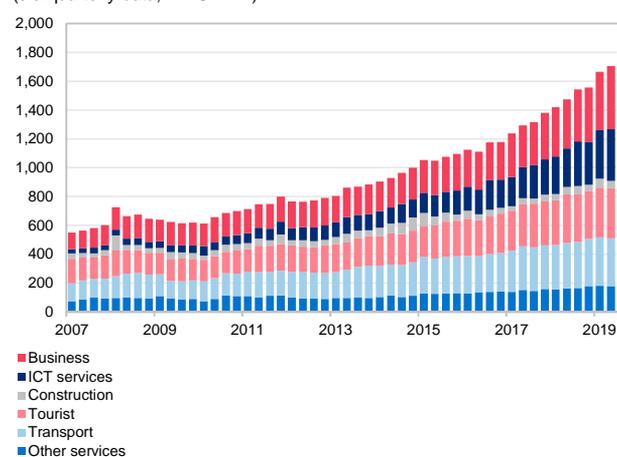
Euro goods imports decelerated to 8.5% y-o-y in Q3 over the slowdown in the imports of intermediate and consumer goods. The imports of intermediate goods slowed (to 6.2% y-o-y) on the back of dented imports of energy products, notably oil and petroleum products, which after the overhaul in the Pančevo refinery, fell by 10.0% y-o-y in Q3. At the same time, investment growth continued to reflect on equipment imports, which increased by 17.5% y-o-y. Although rising at a slower pace (14.7% y-o-y) than in Q2, the imports of consumer

Chart IV.3.3 Exports and imports of goods and services (in previous-year constant prices, ref. 2010)



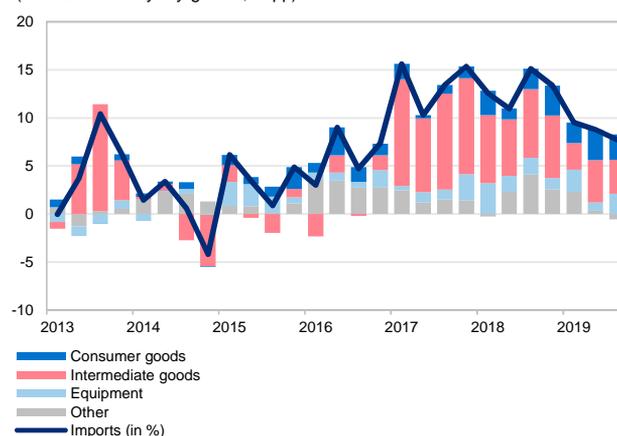
Sources: SORS and NBS calculation.  
Note: NBS estimate for Q3 2019.

Chart IV.3.4 Exports of services (s-a quarterly data, in EUR mn)



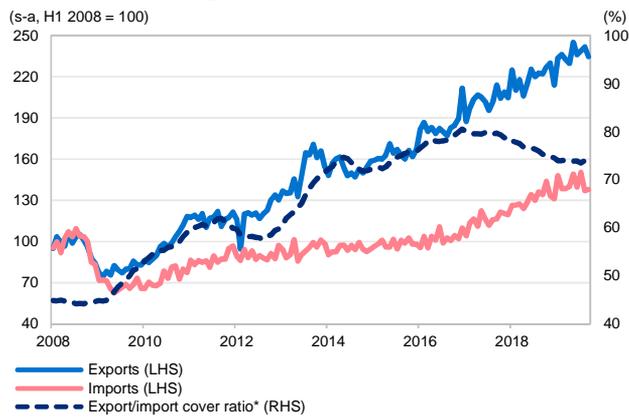
Sources: SORS and NBS calculation.

Chart IV.3.5 Movement of key import components (contributions to y-o-y growth, in pp)



Sources: SORS and NBS calculation.

Chart IV.3.6 Trade in goods in euros



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

goods suggest that household consumption continues to recover. Similar movements are also confirmed by the structure of imports by EU classification, where the largest contribution to imports originated from intermediate goods, as well as non-durable consumer and capital goods, while the contribution of energy products was negative.

The coverage of goods imports by exports in September 2019<sup>16</sup> was 73.9%, or 83.4% including services, which is close to the 2018 levels. In the same month, euro goods exports and imports exceeded their pre-crisis levels<sup>17</sup> by 134.9% and 38.0% s-a, respectively.

<sup>16</sup> Measured by 12-month moving average.

<sup>17</sup> Level from H1 2008.

### Text box 3: Serbia's exports in a global slowdown environment

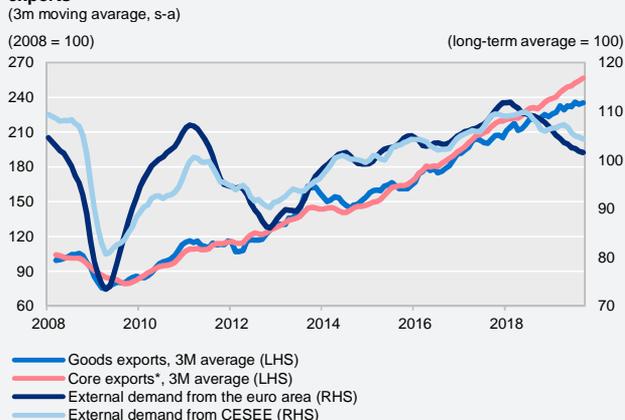
Serbia's exports continue to record relatively high growth rates despite numerous challenges in the international environment. Global growth has slowed, largely weighed down by trade and geopolitical tensions, which weakened international trade and investment. **A special challenge for Serbia is the greater than expected slowdown in the euro area, notably in our key trade partners – Germany and Italy**, whose growth rates are expected at 0.5% and 0% this year.<sup>1</sup> Slowdown has also been experienced by our other important trade partners – countries in the region, which are also largely oriented to the EU market. A turnaround in monetary policies of leading central banks is expected to ensure a stimulus that will mitigate the damaging consequences of rising protectionism and uncertainty over future trade policies on global economic growth.

Despite challenges that the Serbian export sector faces, data on exports in the year so far suggest good performance. In the first nine months of the year, Serbia's total exports continued to record two-digit growth rates (10.9% y-o-y). Exports of goods went up by 8.5% y-o-y and of services by 17.4% y-o-y. This means that **Serbia's exports continue to increase at a faster pace than global (import) demand and that the country's share in the global market is expanding further**. The success of the export sector is particularly important as it contributes to the achievement of other strategic objectives of Serbia, notably sustainable economic growth, rising employment and wages, the narrowing in external imbalances and stability in the FX market.

The solid export performance is supported by data on goods exports in the EU, whose growth decelerated significantly. In the first nine months of 2019, goods exports to the EU were worth EUR 8.7 bn, up by EUR 557 mn (6.8%) y-o-y. **Goods exports to Germany increased the most** (by EUR 184 mn), reaching EUR 1.7 bn. **Exports to 26 EU countries expanded**, while contracting only to Italy and Bulgaria. However, with exports worth EUR 1.4 bn since the start of the year, Italy is our second most important export market. Excluding cars, exports to Italy stayed almost unchanged. In regard to markets outside the EU, after Germany, our exports to China increased the most, by EUR 134 mn, reaching EUR 191 mn, after relatively low levels recorded last year.

In terms of products, growth was recorded for all important export products of Serbia, except for cars and steel. Exports of **agricultural products** are also solid.<sup>2</sup> In the first nine months, the revenue from the export of agricultural products reached EUR 788 mn, up by EUR 142 mn (22.0%) y-o-y. An increase was registered for almost all agricultural products exported by Serbia, most notably cereals (31.1%). This was partly due to high inventories created after the record last year's season as low river levels postponed their exports to foreign markets, as well as to Serbia's comparative advantages in this field, primarily the production of non-GMO crops. We exported most of our agricultural products through the

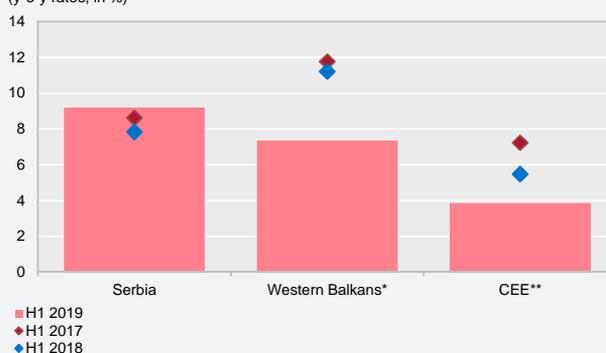
Chart O.3.1 Movement of indicators of external demand for Serbian exports (3m moving average, s-a)



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 O.3.2 Real export growth (y-o-y rates, in %)



Source: Eurostat.

\* Albania, Bosnia and Herzegovina, North Macedonia and Montenegro.

\*\* Poland, Czech Republic, Slovakia, Hungary, Slovenia, Croatia, Romania and Bulgaria.

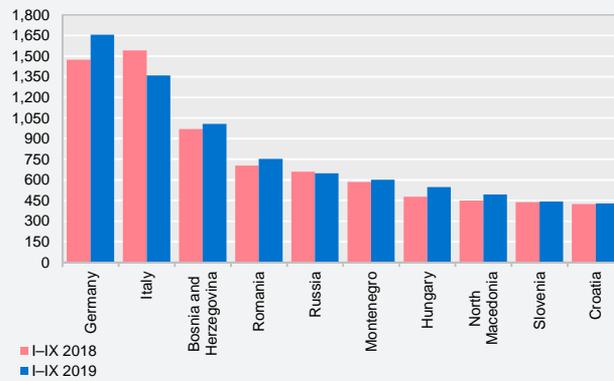
<sup>1</sup> IMF WEO (October 2019).

Romanian Port of Constanța, and to Russia. Serbia has the potential to further increase the export of agricultural products, along with further improvement of the efficiency of export logistics and connectivity of the river, road and railway transport, the expansion of port capacities and construction of new silos, primarily on the Danube, and the modernisation of our river fleet.

The agriculture-related **food industry**<sup>3</sup> is also recording solid export results. It earned over EUR 1.2 bn worth of export-revenue in the first nine months of this year, up by EUR 88 mn y-o-y. Exports by country are broad-based – in addition to all countries of the region, important buyers of food products are also Germany, Russia, Italy, France etc. Although not high on the list of our important export markets for food products, since the start of the year exports to Asian countries (primarily China) have also increased, as well as exports to South America and the Near East. The export results of the food industry are supported by Serbia's significant surpluses in this field, and the progress achieved in terms of defining quality and obtaining relevant certificates, including development of the network of modern cold storage plants, application of state-of-the-art processing techniques (lyophilisation) and organic production.

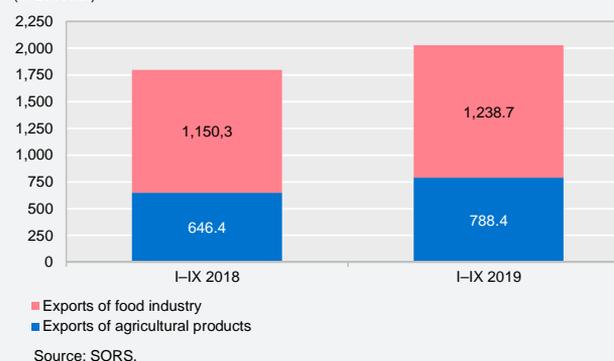
**Auto component** manufacturers are also recording good export results, despite being exposed to exceptionally unfavourable trends in the global market. In the nine months of this year, their exports went up to EUR 1.5 bn (by EUR 165 mn or 12.1%) y-o-y, despite the falling production of the car industry at the global level, especially in Germany, which is our key export market. The global downturn in the car industry, in place since last year, when it was recorded for the first time since the outbreak of the global economic crisis, is explained primarily by two factors: the abolition of tax incentives for car purchases in China, which is the largest market in the world, and the tightening of car standards for carbon emissions in the euro area. Companies from Serbia are the suppliers of large systems, especially in Germany, which reduced its production by one million cars, to the 2009 level. Despite this, the exports of car components from Serbia to Germany increased the most (by EUR 65 mn or 19.4%), followed by the Czech Republic (by EUR 27 mn or 30.6%), Hungary (by EUR 15 mn or 14.8%) and Austria (by EUR 12 mn or 35.5%). In

Chart O.3.3 **Top ten export markets of Serbia**  
(in EUR mn)



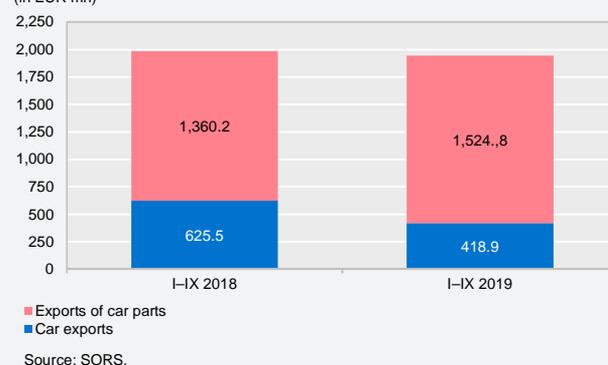
Source: SORS.

Chart O.3.4 **Exports of agricultural sector**  
(in EUR mn)



Source: SORS.

Chart O.3.5 **Exports of car industry**  
(in EUR mn)



Source: SORS.

<sup>2</sup> Agricultural products include products of agriculture, forestry and fishing (Classification of activities, sector A).

<sup>3</sup> Food products include the production of food products (Classification of activities, 10).

addition to Germany (with a 26.4% share), since the start of the year the most important buyers of auto components from Serbia have been the Czech Republic (7.6%), Slovakia (7.5%), Hungary (7.4%) and Great Britain (6.3%).

The car industry produces important economic effects. It is the main consumer of other products of manufacturing and services: it is the second largest consumer of steel and aluminium (following construction), and its demand for copper, rubber, plastic and electronics is significant. Therefore, Serbia's inclusion in production chains is of immense importance. Serbia's main comparative advantages in this field are primarily quality engineering staff and technical skills of the workforce, including the exceptionally favourable strategic location. The cluster of manufacturers of parts and components for the car industry employs around 50,000 workers and is the largest industrial branch of Serbia, with the potential for further growth.

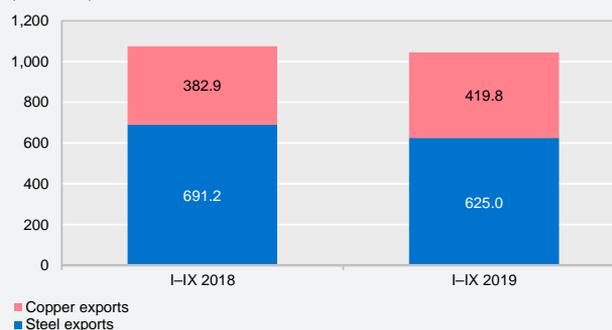
In terms of global prospects for the car industry, following a 4% drop this year, the IMF expects stagnation next year. The growth prospects in Europe are under the impact of several factors, notably dented demand for diesel cars, uncertainty surrounding Brexit and emission tests to come into force in late 2019. Also, potential introduction of duties by the US on the imports of cars and parts from the EU could negatively affect the production of the car industry in Europe. The IMF emphasises that the factors affecting the medium-term prospects of this industry will be further efforts aimed at decarbonisation and a significant increase in investment in the production of electric cars.

In the first nine months of this year, higher exports of automobile clusters largely compensated for the lower exports of cars (by EUR 207 mn y-o-y). Car exports were worth EUR 419 mn, owing mostly to exports to Italy (74.4%) and to a significantly lesser extent to Montenegro, Bosnia and Herzegovina, Germany, and other countries.

In addition to the exports of cars, out of important Serbian products, only the export of **steel** contracted, but this was largely compensated by the higher export of **copper**. In the first nine months of this year, steel exports declined by EUR 66 mn from EUR 691 mn, which was the amount exported in the same period last year. The value of exports declined due primarily to falling prices of steel products, particularly hot rolled products, which are the most important export product of the Serbian steel plant. Although the quantity of exported steel products stayed broadly unchanged (up by 0.1%) in the period observed, the past several months have witnessed a reduction in exports in tonnes as well, on account of the EU safeguard measures in the form of import quotas on the 26 steel products, applied as of February this year and in effect until July 2021. A global quota was introduced for hot rolled products. Individual quotas were introduced for the remaining two categories of products of the Serbian steel plant – cold rolled and tin mill products; the basis of these quotas is the average of imports from Serbia in the 2015–2017 period. Any imports over these quotas will be subject to a 25% duty. Such quotas are not favourable for the steel plant in Serbia, which is owned by the Chinese company Hesteel since 2016, because the average of cold rolled steel is by around 10% lower than last year's exports to the EU, and by around 25% lower in the case of tin mill products.

It is envisaged that customs quotas will be adjusted to changing circumstances, e.g. in the case of an increase or reduction of EU demand for particular categories of products. Last year, the EU imported the largest quantity of steel from Turkey (21.0% of total steel imports), Russia (12.7%), South Korea (11.7%), China (9.6%) and India (9.5%). A visible change in the EU steel market is the constant rise in steel imports from Turkey since 2015 and overtaking the primacy from China, whose share in 2015 was close to 30% of total EU steel imports. Serbia takes the eighth place on the list of the most important steel exporters to the EU, with 1.1 mn tonnes or a 3.7% share in total EU steel imports.

Chart O.3.6 **Copper and steel exports**  
(in EUR mn)



Source: SORS.

**Vigorous export growth is led by enterprises with robust FDI inflows, as well as by new domestic enterprises.** The improvement of macroeconomic fundamentals and the business environment, confirmed by the upgrade of the credit rating, Serbia's progress on international competitiveness lists and high FDI inflows, has enabled a faster rise in investment and higher productivity of the export-oriented segment of the economy. In addition to ensuring vibrant export growth and the narrowing in external imbalances, new investment projects, distributed across a large number of export-oriented branches, led to the **higher diversification of exports, observed by product and country. This is suggested by the reduced Herfindahl-Hirschman Index<sup>4</sup>** – to 0.19 by product, and to 0.24 by partner country in 2018. It should be borne in mind that we export cereals mainly through Romania, and motor vehicles through Italy, wherefrom they go to other countries, which is why the real degree of concentration of exports, observed by country, is in fact smaller than suggested by the Index. What supports the adequate export structure is the high share of products where Serbia has a considerable comparative advantage in total exports of around 80%, for which there is, at the same time, adequate demand in the global market, as also confirmed by the progress achieved in the sectoral specialisation of exports.

<sup>4</sup> We observed the level of Serbian exports concentration by product and country, measured by the Herfindahl-Hirschman Index:

$$HHI = \left[ \sum_{i=1}^n \left( \frac{X_i}{X_t} \right)^2 \right]$$

where  $X(i)$  is exports of a particular product of the country and  $X_t$  is total exports of the country. The lower the Index, the lesser the concentration of the country's exports.

## 4 Economic activity

*The recovery of manufacturing after the finished overhauls in oil and chemical industries, as well as a further rise in construction and services, boosted GDP growth in Q3 to 4.7% y-o-y (1.8% s-a). Growth is likely to stay relatively high in Q4 as well, underpinned primarily by the activation of new production capacities in industry, which is why we expect economic growth in 2019 as a whole to reach 3.6%.*

**GDP growth accelerated to 1.8% s-a in Q3**, for the 20<sup>th</sup> consecutive quarter. Unlike Q2, when industrial output was declining, in Q3 the recovery of chemical and oil industry after the finished overhauls boosted industrial output, providing a positive contribution to GDP growth (0.5 pp). Similarly as in H1, economic growth was supported by the rise in services (1.0% s-a) on account of increased personal consumption, development of the transport sector owing to the construction of infrastructure, higher inflow of tourists and so on. Further improvement of the investment climate and the implementation of infrastructure projects oiled the wheels of growth in the construction sector which exceeded 10.0% s-a in Q3 and added 0.5 pp to the quarterly GDP growth.

Owing to the continuous growth in the past five years, s-a economic activity went up by 17.7% in Q3 measured by GDP and by 21.0% measured by NAVA, relative to the pre-crisis period<sup>18</sup>.

The physical volume of production in manufacturing grew by 4.3% s-a in Q3, largely as a result of the restored full volume of production in oil and chemical industries. In addition, the production of beverages recovered in Q3, and growth was recorded also in the production of rubber and plastic products. Looking at the overall manufacturing sector, 12 out of 24 branches recorded growth. On the other hand, the largest negative contribution came from the dampened production of base metals and motor vehicles, while the decline in the food industry slowed down.

The volume of production in mining was cut by 2.8% s-a on account of reduced exploitation of oil and crude metals. In addition, electricity supply also slumped (5.9% s-a), dampening the growth in the physical volume of industrial production to 2.1% s-a.

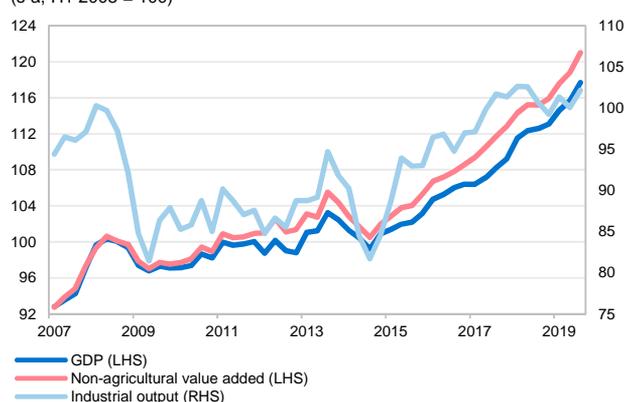
Table IV.4.1 Contributions to y-o-y GDP growth (in pp)

	2018		2019		
	Q3	Q4	Q1	Q2	Q3*
<b>GDP (in %, y-o-y)</b>	<b>4.1</b>	<b>3.4</b>	<b>2.7</b>	<b>2.9</b>	<b>4.7</b>
Agriculture	1.2	1.0	0.0	0.0	0.0
Industry	-0.2	-0.6	-0.3	-0.5	0.5
Construction	0.4	0.1	0.3	0.7	1.7
Services	2.0	2.2	2.0	2.0	2.1
Net taxes	0.5	0.5	0.5	0.5	0.5

Sources: SORS and NBS calculation.

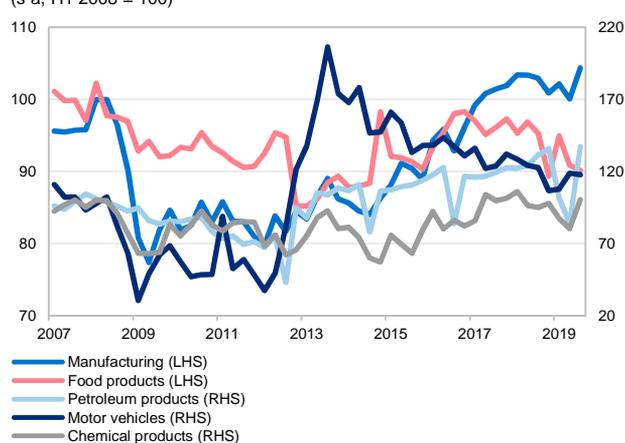
\* NBS estimate.

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



Sources: SORS and NBS calculation.

Chart IV.4.2 Physical volume of production by branch of manufacturing (s-a, H1 2008 = 100)

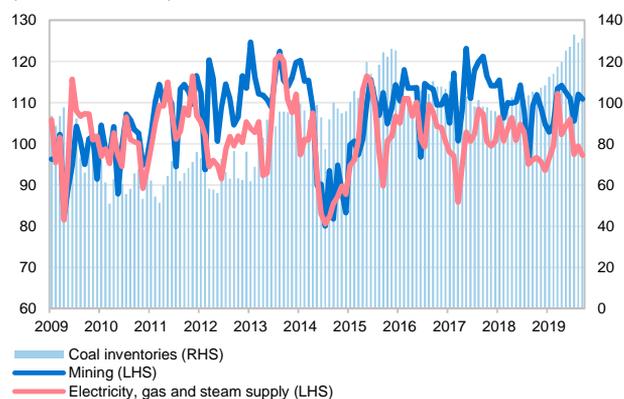


Sources: SORS and NBS calculation.

<sup>18</sup> Level from H1 2008.

**Chart IV.4.3 Physical volume of production in energy and mining**

(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Intensive growth of the construction industry is powered by investments of both government and private sector. Namely, the rise in government capital expenditures continued in Q3, which indicates stronger implementation of infrastructure projects. Also, the number of issued construction permits increased (6.3% s-a in the July–August period) on the back of improved investment climate, reflected, inter alia, in the simplified procedure for the issuance of construction permits. This is also confirmed by Serbia's progress on the latest Doing Business list by four notches. Among 190 countries, Serbia ranked 44<sup>th</sup>, while achieving the best progress in the area of construction permit issuing (9<sup>th</sup> position). In Q3 the production of construction materials increased by 2.3% s-a, while formal employment in construction rose by 4.0% compared to Q2.

**Chart IV.4.4 Construction activity indicators**

(quarterly averages s-a, 2017 = 100)

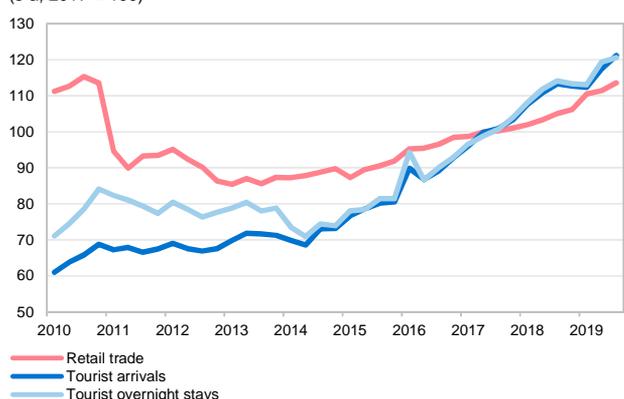


Sources: SORS and NBS calculation.

Positive trends continued in all service sectors, which can be attributed to the rise in personal consumption, underpinned primarily by favourable labour market trends. We estimate that the growth in services reached 0.9% s-a. Similarly as in past quarters, the greatest contribution to the rise in services came from trade, transport and tourism (1.5% s-a). This is also confirmed by indicators in these branches in Q3 since retail trade rose by 2.0% s-a, and the number of tourist arrivals and overnight stays went up by 3.1% s-a and 1.0% s-a, respectively.

**Chart IV.4.5 Service sector indicators**

(s-a, 2017 = 100)



Sources: SORS and NBS calculation.

GDP growth amounted to 4.7% in Q3 exceeding our expectations stated in the previous *Report*. Growth acceleration relative to Q2 (2.9% y-o-y) is for its major part attributable to the recovery of industrial production and a step-up in the construction sector. Namely, after a 2.2% y-o-y fall in H1, industrial production increased in Q3 by 2.2% y-o-y, according to our estimates. Construction growth stepped up to 35% y-o-y in Q3. As a result, industrial production and construction contributed 2.2 pp to GDP growth. Like in the quarter earlier, economic growth in Q3 was based on the pick-up in services (4.2% y-o-y, 2.1 pp contribution to growth). On the other hand, after above-average agricultural season, the contribution of agriculture to GDP growth is estimated to have remained neutral in Q3.

Since vibrant economic growth is rather likely to continue until the end of the year, we have raised our GDP growth projection for 2019 to 3.6%. We estimate that the expected recovery of the mining sector will push the industrial activity further up in Q4. Besides, we expect the upward trend in services and construction to be sustained. As for agricultural sector, preliminary data of the Statistical Office point to the lower wheat production (by

13.8%). On the other hand, the late crops output is expected to increase (corn by 7.7% and soybean by 8.5%), while minimum changes are expected for the sunflower and sugar beet production. Bearing this in mind, as well as the expected growth of some fruit crops, we estimate that agricultural production will be almost unchanged in 2019, which differs from our previous expectation when we thought that in conditions of average agricultural season the agricultural contribution to this year's GDP growth would be negative.

## 5 Labour market developments

*Favourable labour market trends in Serbia continued – Q3 saw a further rise in wages, increase in formal employment and a reduction in the unemployment rate. The overall economic productivity is on a steady rise.*

### Wages and labour productivity

Posting 10.3% y-o-y growth, **total nominal net wage reached RSD 54,579 (EUR 463) on average in July and August 2019**. The nominal net wage in the public sector<sup>19</sup> recorded the same increase as the total nominal net wage, while the one in the private sector rose by 10.7% y-o-y. Amid continued economic growth, low and stable inflation and secured fiscal room, the Serbian Government, in line with prior announcements, passed the decision on the **increase in the minimum hourly wage by 11.1%** from RSD 155.3 to RSD 172.5 (net amount), which will become effective in early 2020. Thus, the minimum wage will come additionally closer to the minimum consumer basket, covering it by around 80%.

**The y-o-y rise in nominal net wages was recorded in all branches of the economy in July and August**, primarily in information and communications, mining, energy and agriculture. Higher wages than in the same period last year were also recorded in manufacturing and services (construction, trade, transport, etc.) where the private sector is dominant and in public administration, health and education where the public sector is prevalent. Besides, amendments to the Law on the Budget System also envisage a public sector wage increase by 8–15% as of November.

The public and private sector wage increase accompanied with the rise in employment pushed up the total nominal net wage bill, by 14.1% y-o-y in July and August.

<sup>19</sup> For the purposes of average wage calculation, the Statistical Office classifies the following under the public sector: public enterprises, public local utilities, all levels of administration, public institutions performing health and social protection, educational and cultural activity.

Chart IV.5.1 Average nominal net wage (in RSD thousand)

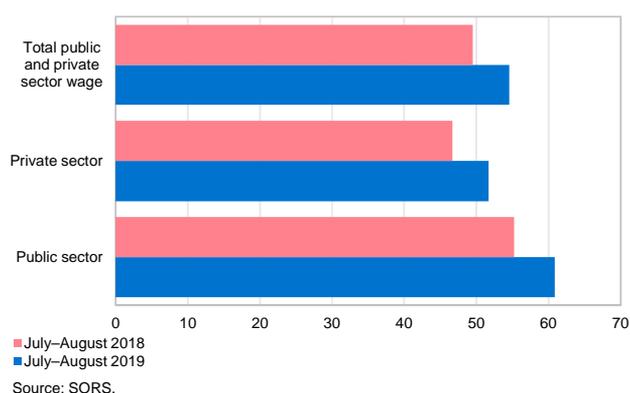


Chart IV.5.2 Nominal net wage by economic sector (in RSD thousand)

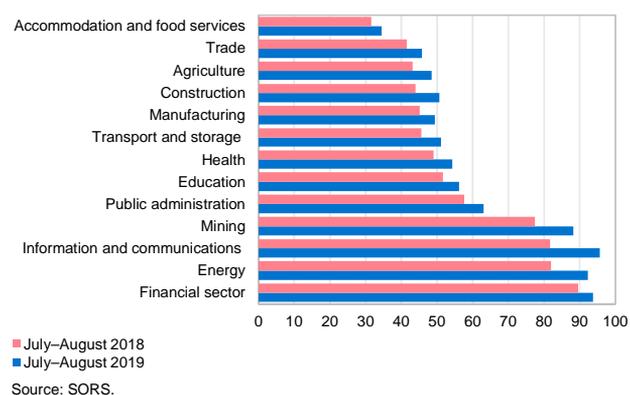
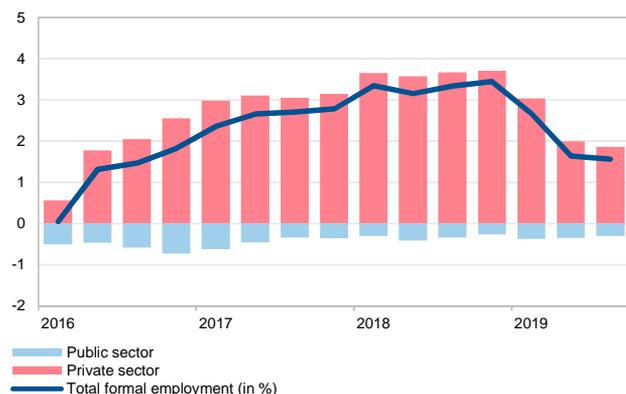


Table IV.5.1 Formal employment and unemployment (y-o-y growth rates, period average)

	2018		2019	
	Q4	Q1	Q2	Q3
Total number of formally employed	3.4	2.7	1.6	1.6
Employed with legal persons	3.4	2.6	1.9	1.7
Entrepreneurs and their employees	6.4	5.3	2.8	3.0
Individual farmers	-8.3	-8.3	-8.7	-8.6
Unemployed	-10.8	-9.1	-9.3	-9.5
First-time job seekers	-11.5	-1.6	21.1	26.1
Used to be employed	-10.5	-12.7	-24.3	-27.2

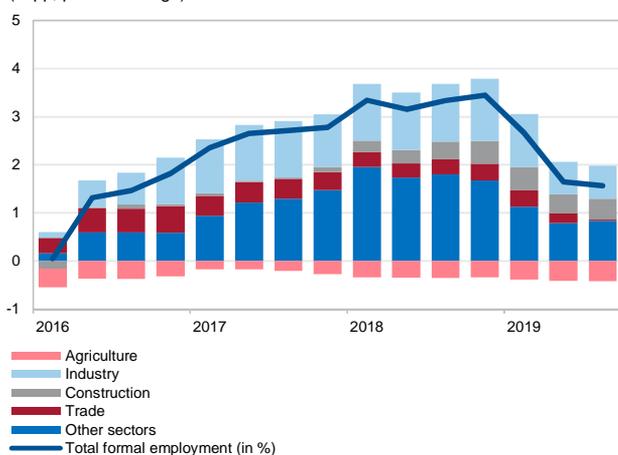
Sources: SORS and NES.

Chart IV.5.3 Structure of y-o-y growth in total formal employment (in pp, period average)



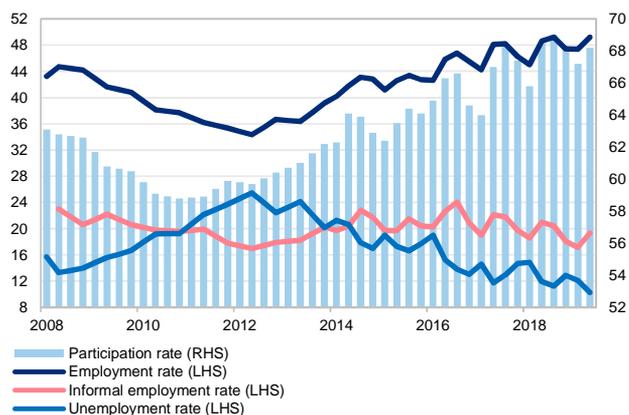
Sources: SORS and NBS calculation.

Chart IV.5.4 Contribution to y-o-y growth in total formal employment by economic sector (in pp, period average)



Sources: SORS and NBS calculation.

Chart IV.5.5 Labour market indicators according to the Labour Force Survey (in %)



Source: SORS.

With the economy rising faster than employment, **overall economic productivity accelerated to 2.4% y-o-y in Q3**, according to preliminary estimates. This trend should continue in the coming period on account of FDIs channelled to projects and areas with higher value added.

## Employment

In Q3 formal employment kept increasing at the same pace as in Q2 (1.6% on average) on account of a further rise in employment with legal entities, private entrepreneurs and their employees.<sup>20</sup> A contribution also came from the increased activity of the working age population and further reduction in unemployment. On the other hand, the number of individual farmers and those working in agriculture declined in Q3, similarly as in the previous period.

**Increase in the private sector employment (2.6% y-o-y in Q3)** has, for a while, been **the main driver of formal employment gains**, primarily manufacturing and construction, and the rest of service sectors which are also the drivers of economic growth. As opposed to that, in Q3 employment decreased in energy and predominantly public sector industries (by 6.4 thousand people y-o-y) due to the still ongoing rightsizing process.<sup>21</sup>

**Q3 saw the continuation of multiannual downward trend in registered unemployment** on the back of implementation of active labour market policies (ALMP)<sup>22</sup> and more favourable business and investment climate in Serbia. According to the National Employment Service (NES), unemployment reached **a new low, with 502,561 unemployed persons in September**, or around 51 thousand people less than the year before. Compared to Q3 2014, when labour market reforms were initiated in Serbia, unemployment was cut by almost 248 thousand persons, which is another confirmation of the progress achieved. At the same time, unemployment dropped y-o-y in Q3 in all occupation groups, but mostly in manufacturing (mechanical engineering and metal processing, electrical engineering, chemistry and non-metals, etc.) Unemployment also shrank in occupations related with trade, catering and tourism, followed by agriculture and food production, and construction and transport.

<sup>20</sup> Statistical Office data obtained from the Central Registry of Mandatory Social Insurance.

<sup>21</sup> Pursuant to the Law Setting the Maximum Number of Employees in the Public Sector.

<sup>22</sup> ALMPs include, inter alia: job matching services, career guidance and counselling, support to self-employment, further education and training, special programmes for youth in transition from the education system to the labour market, etc.

### Text box 4: Positive labour market trends in Serbia

Serbia’s labour market recovered in the past five years amid favourable macroeconomic developments, i.e. synergy effect of a number of factors – successful coordination of economic policy measures, accelerated economic growth, more favourable business and investment climate and work conditions, as well as implementation of active labour market policies (ALMPs) which helped **increase labour market participation and employment as well as decrease unemployment**. The Law on Labour passed in mid-2014 yielded a significant impact on the labour market dynamics as it introduced the following novelties: maximum duration of fixed-term employment contract was extended from one to two years; additional forms of employment (work from home and part-time work) were envisaged; payment of severance pays and calculation of the bonus for accumulated years of service spent with the last employer; base wage without bonuses was taken as the base for the calculation of the rate for the holiday pay, etc. Amendments to the regulatory and legal framework towards more flexible labour legislation had a slightly restrictive impact only to gradually increase labour market efficiency as indicated by the key labour market indicators from LFS – **the participation, employment and unemployment rates**. The improvement of labour market indicators becomes all the more significant in light of the fact that Serbia, like many countries in Europe and worldwide, is facing adverse demographic trends, first and foremost depopulation and emigration processes.

**The activity (participation) rate**, calculated as the share of labour force (all employed and unemployed persons) in the working age population, has been on the rise since 2014. For working age population (15–64), this rate has stood at 63.3% on average since 2014 (55.4% for women and 71.3% for men). **The participation rate went up in the past five years (by 4.9 pp on average) with the female participation rate increasing faster** (particularly among women with higher education) than the male. In parallel with activity, **the employment rate increased** in the period from 2014 until Q2 2019 (by 7.2 pp, to 49.2%) with almost the same male and female employment growth.

Greater activity of the population is noticeable in all regions of the country with the highest participation rate in the Belgrade region – from the average 63.9% in 2014 it reached 71.8% in Q2 2019. What is interesting is that the second highest rise in the observed period was recorded in the region of Southern and Eastern Serbia where in 2018 the activity was on average 4.8 pp above the level from five years ago. Direct greenfield investments facilitated the opening of new production capacities throughout Serbia to stimulate local population activity and hence employment in different parts of the country. **At end-Q2 2019 the highest employment rate was measured in the Belgrade region (52.5%) and Šumadija and Western Serbia (50.0%).**

Chart O.4.1 Activity rate (15–64) and employment rate (15+) by gender (period average, in %)

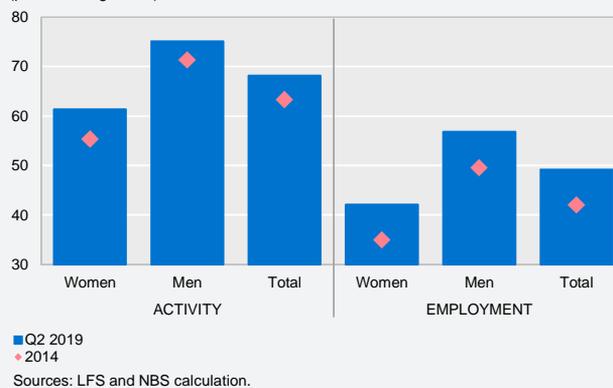
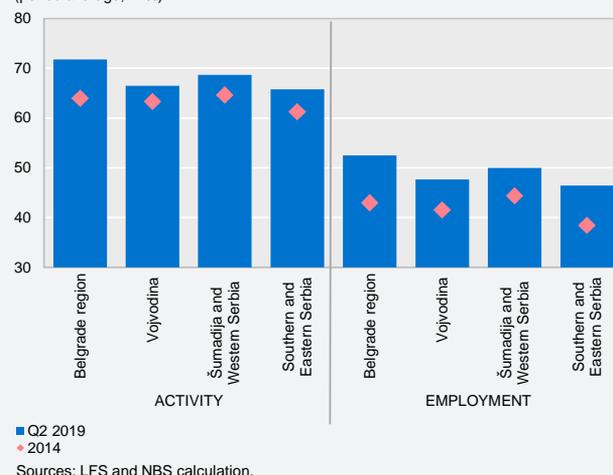


Chart O.4.2 Activity rate (15–64) and employment rate (15+) by region (period average, in %)



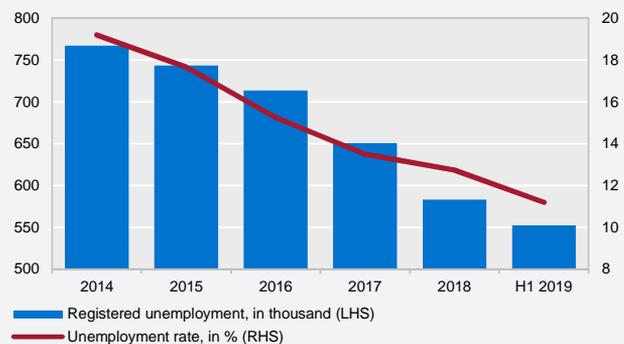
**The rise in activity and employment was coupled with a considerable reduction in the unemployment rate** (according to LFS), which was virtually halved in the past five years – from 20.7% in Q2 2014 to 10.3% in Q2 2019. Furthermore, for the first time in the observed period the total number of people who have been unemployed for a year or longer fell below 200 thousand, bringing the long-term unemployment rate to the lowest level thus far (6.1% in Q2 2019). The youth unemployment rate was also halved in the observed period, reaching 24.4% in Q2 2019. The records of the National Employment Service (NES) on **registered unemployment** point to similar conclusions. Namely, **the number of the unemployed registered with the NES has been continuously declining, and it reached a new low of 502,561 in September 2019**, almost 265 thousand unemployed persons down compared to the average level from 2014.<sup>1</sup>

As for registered employment, **the total number of the formally employed<sup>2</sup> rose significantly in the past five years**. The number of employed persons in H1 2019 was 2,154,741 on average, or almost 195 thousand employed persons more than in H1 2014. Formal employment rose primarily in the private sector with more than 1.5 mn persons in H1 2019 and the average growth of 16.5% from H1 2014. At the same time, public sector employment dropped by 4.1% to less than 600 thousand persons as the public sector rightsizing is still ongoing. **Services and industry employed close to 2 million people on average in H1 2019**, or over 230 thousand persons more than in the same period of 2014, with 86 thousand of those in manufacturing.

Employment in construction has been noticeably on the rise since 2018 and around 13 thousand persons more were employed in the five year period, while only the number of registered individual farmers and employed persons in that branch decreased (by around 50 thousand), where, in fact, the highest incidence of precarious jobs (self-employed and contributing family members) is recorded. The share of informal employment (percentage of people working without a formal employment contract in total employment) decreased in parallel with an increase in formal employment, from the average 21.2% in 2014 to 18.2% in H1 2019 on the back of intensified inspection supervision and more efficient combat against the grey economy.

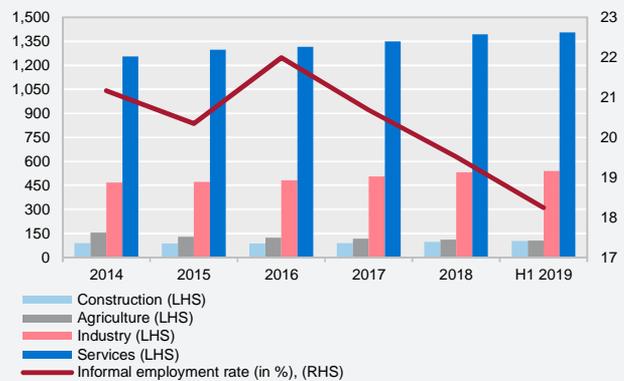
Looking at the working age population and active population in the period 2014–2018, **it can be observed that Serbia was the leader in terms of the activity and employment growth rate dynamics<sup>3</sup> compared to other Western Balkan countries** (with the exception of Albania) **and EU member states in the vicinity** (with the exception of Hungary). In parallel with that, Serbia has also been reducing the unemployment rate fast. In H2 2019 Serbia's unemployment rate was the lowest on record and the lowest in the group of Western Balkan countries.

Chart O.4.3 **Unemployment**  
(period average)



Sources: NES and LFS.

Chart O.4.4 **Formal employment by sector**  
(period average, in thousand)



Source: CRCSI, LFS and NBS calculation.

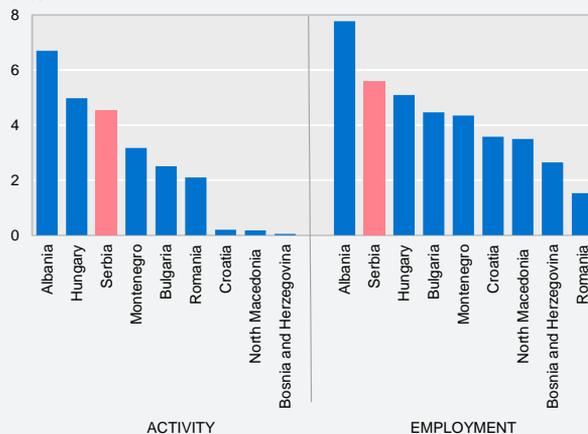
<sup>1</sup> Since this period only active job seekers count as unemployed, pursuant to the Law on Employment and Unemployment Insurance.

<sup>2</sup> According to the records of the Central Registry of Mandatory Social Insurance and Statistical Business Registry.

<sup>3</sup> Labour market indicators across countries are integrated and published by Eurostat based on the national labour force surveys, while the data for Albania and Bosnia and Herzegovina are available through their state statistical agencies.

**One more indicator speaks in favour of improved labour market conditions in Serbia – the Beveridge curve,** a representation of the relationship between the number of the unemployed and the number of vacancies (with registered recruitment needs used as a proxy). Despite certain limitations<sup>4</sup>, the Beveridge curve can serve as an indicator of labour market dynamics and conditions depending on the phase of the business cycle and on structural changes in the economy. **In the observed period the curve for Serbia shifted to the left, indicating increased labour market flexibility and efficiency in matching labour market supply and demand, and the spill-over of the overall economic recovery to the labour market through job creation and unemployment cuts.** In H1 2014 when labour market conditions were rigid, around 3 thousand vacancies and around 785 thousand unemployed persons were recorded, on average. The situation gradually improved and in the next two years the average number of vacancies rose to around 6 thousand and the number of unemployed people dropped to around 743 thousand on average in 2015 and 713 thousand in 2016. Growing recruitment needs were recorded in 2017, and especially in 2018. In H1 2019 the number of vacancies reached almost 8 thousand and the average number of unemployed people plummeted to the lowest level on record (around 552 thousand). **This was facilitated by a more stable macroeconomic environment, FDI inflows and companies’ better operating and financial results, which shifted the Beveridge curve in the desirable direction.**

Chart O.4.5 Changes in activity and employment rates in Serbia and neighbouring countries from 2014 until 2018 (in pp)



Source: Eurostat, national LFS and NBS calculation.

Chart O.4.6 Beveridge curve for Serbia

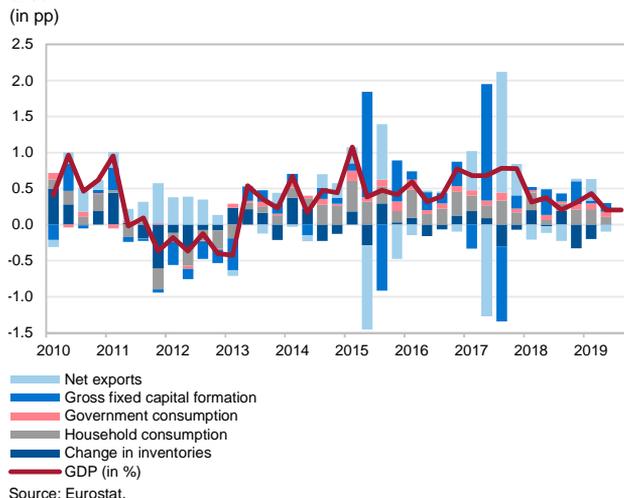


Sources: NES and NBS calculation.

Bearing in mind the progress achieved in the Serbian labour market so far, and the fact that increasing activity and employment are the priorities and strategic goals of the Serbian Government, the continuation of positive labour market trends is expected in the period ahead, with further structural improvements and the unemployment rate coming close to a single-digit level.

<sup>4</sup> The data on vacancies do not include the total labour market demand, since the current Law does not oblige employers to hire workers through the NES. The unemployment rate can also be used for the representation of the curve but then the sources of data differ as well as the pace of their publication.

Chart IV.6.1 Contributions to s-a GDP growth rate of the euro area (in pp)



## 6 International environment

*In the period since the previous Report, global growth continued to slow down, displaying a trend present in both advanced and emerging countries. This can be attributed to a series of factors, notably the introduction of trade barriers and rising geopolitical tensions which resulted in slower production activities and trade, and shaken business confidence. Low inflationary pressures created a favourable environment for leading central banks' monetary policies to endorse economic growth. Monetary policy easing in advanced countries and stepped-up disinflationary external pressures helped preserve favourable monetary conditions in emerging economies and, in some cases, created room for central banks in these countries to trim their key policy rates.*

### Economic activity

With the world economy slowing down for the major part of 2018, **global growth remained sluggish during H1 2019 as well**, mostly due to the significantly subdued production activity and trade. This is also indicated by the Global Manufacturing PMI, which, after reaching a historical minimum in July, improved slightly in September (49.7), though still lingering below the neutral level. Geopolitical tensions have persisted, and trade tensions were reawakened with the introduction of new USA–China customs barriers, reflecting negatively on global trade, business confidence and investment. Though this affects financial conditions as well, they remained largely favourable in conditions of further monetary policy accommodation in the euro area, USA and other advanced and emerging countries, while the largely stable services sector drove employment growth up. Still, caution is mandated in terms of future growth prospects, which is why risks to the projection remain skewed to the downside.

Chart IV.6.2 Movements in GDP and economic activity indicators of the euro area

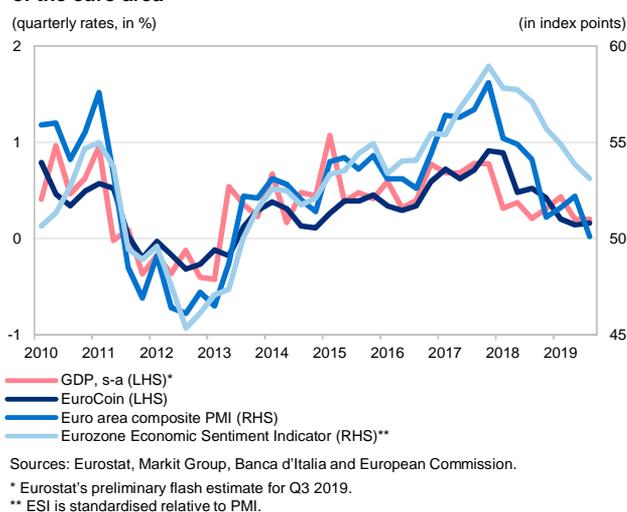
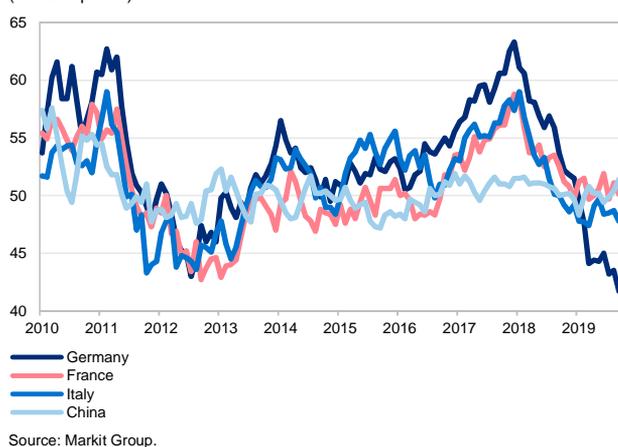


Chart IV.6.3 PMI Manufacturing for selected countries (in index points)



After an unexpected acceleration of growth in Q1 (0.4% s-a), **euro area economy** slowed down in Q2 (0.2% s-a), as suggested by the leading economic activity indicators. In Q2 domestic demand remained the main driver of GDP growth (contribution of 0.3 pp), while a decline in net exports acted in the opposite direction (-0.1 pp). The Italian economy expanded at the rate of 0.1% s-a for two consecutive quarters, endorsed by a rise in fixed investments and the recovery of export activity. Germany's GDP<sup>23</sup> declined 0.1% s-a in Q2 due to dampened industrial activity and external demand,

<sup>23</sup> Germany and Italy are Serbia's key foreign trade partners in the euro area.

however, Bundesbank is optimistic as to avoiding recession.

Relative to the June forecast, the **ECB** stated in September that the euro area economic recovery (forecast for H2) would be delayed under the impact of a lower volume of global trade amid rising protectionism, a possibly greater slowdown in Chinese economy and the no-deal Brexit,<sup>24</sup> which mostly reflected on the manufacturing industry. Despite the Eurozone PMI Composite falling to its lowest level in six years (51.2<sup>25</sup> on average in Q3) and the Economic Sentiment Indicator for the euro area worsening (102.5<sup>26</sup> on average in Q3), both indices are still in the expansion zone. Activity in the services and construction sectors continued up, albeit at a slower pace, with improvements in the labour market, where the unemployment rate declined to 7.5% in September (its lowest level since July 2008). According to Eurostat's flash estimate, growth in Q3 was maintained at the Q2 pace of 0.2% s-a. With this in mind, the ECB slightly revised down its euro area projection in 2019 (from 1.2% in June to 1.1% in September), before its gradual increase over the next two years.

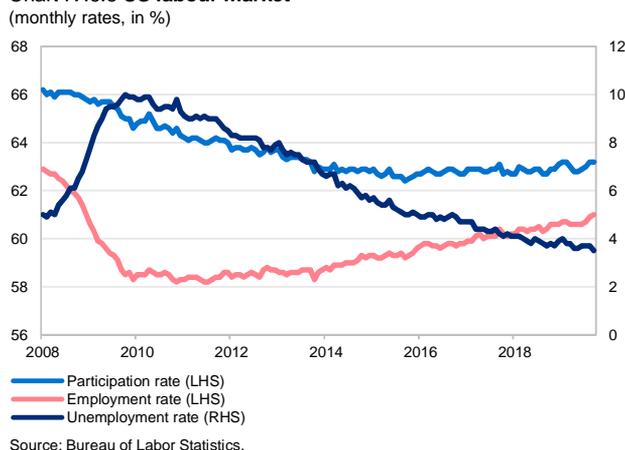
After accelerated growth of 0.8% s-a in Q1, the **US economy** slowed down to 0.5% s-a in Q2. According to the estimate of the Bureau of Economic Analysis, a global slowdown to 2.0% annually in Q2 (from 3.1% in Q1) is attributable to the contraction in exports and investments (primarily in inventories), with a negative contribution to GDP growth (-1.8 pp in aggregate), which was nevertheless compensated by higher contributions from personal and government consumption (3.8 pp in aggregate). However, the ISM Manufacturing PMI in the USA dropped to its lowest level in ten years in September (47.8), indicating a lower volume of production, new orders and suppliers' deliveries. According to the Bureau's preliminary estimate, growth decelerated slightly in Q3, to 1.9% annualised. In regard to this, the **Fed** estimated in September that for the remainder of the year the US economy would rise more slowly than in H1 due to a more modest contribution from private sector investments and government spending, with GDP growth projected at 2.2% for the whole of 2019.

As in Q2, the US labour market continued to record positive trends, as attested by the average increase in the

Chart IV.6.4 Leading economic indicators in the USA



Chart IV.6.5 US labour market



<sup>24</sup> Meanwhile, the negotiating parties reached a preliminary Brexit deal allowing Great Britain to leave the EU after 46 years. EU officials agreed to extend the Brexit deadline until 31 January 2020.

<sup>25</sup> Index value above 50 points indicates expansion, and below 50 a decline in economic activity.

<sup>26</sup> The index has been designed to indicate long-term average with 100 points.

participation and employment rates by 0.3 pp each, to 63.1% and 60.9% respectively, in Q3. In the same period, the number of new non-farm payroll jobs increased to around 160,000. At the same time, the unemployment rate is still trending at its lowest level in half a century (3.5% in September). The Fed forecasts stable movements in the unemployment rate going forward, noting that it will trend below its natural level.

Stable domestic demand, supported by fiscal incentives, continues to ensure solid growth in the **region of Central Europe**, despite slower y-o-y GDP growth in countries of the region in Q2 relative to Q1, notably in Slovenia (from 3.3% to 2.5%), Poland (from 4.7% to 4.1%) and Hungary (from 5.3% to 4.9%). Such dynamics is also attributable to external challenges (dampened global growth and trade), as well as the fact that economies in the region are reaching the peak in their business cycle. Therefore, economic growth is projected to slow down next year, under the impact of lower export and inflow of EU funds.

Similar developments were recorded in the **Southeast European region**, where economic growth will also be driven by domestic demand, mainly healthy private consumption and capital investments. Compared to Q1, economic growth of countries in the region slowed down in Q2 – in Croatia (from 3.9% to 2.4%), Bulgaria (from 4.8% to 3.7%) and Romania (from 5.0% to 4.4%). For the remainder of the year, growth in the region is estimated to rise at a slower pace amid dampened external demand from the euro area and trade tensions.

**The Russian economy** recorded y-o-y growth of 0.9% in Q2 (0.5% in Q1), owing to an increase in final consumption and a smaller decline in gross investments relative to Q1. Nominal wages rose 7.7% y-o-y in Q2 and the unemployment rate dropped to its lowest level (4.6%). According to estimates of Russia's national statistical office, Q2 saw a further improvement in the consumer confidence index, as inflation struck a downward path owing to the waning of effects of the VAT increase early in the year.

**China's economic growth** slowed down in y-o-y terms since the start of the year – initially from 6.4% in Q1 to 6.2% in Q2, only to decelerate additionally to 6.0% in Q3, as estimated by China's National Bureau of Statistics. The weakening in China's GDP is not attributable solely to the renewed trade tensions with the USA and the ensuing fall in external demand, but also to the subdued domestic demand in a situation when tax breaks for car purchase are being revoked and new regulations on harmful gas emissions are being introduced. In October, the IMF

estimated that the regulatory framework needs to be strengthened in order to constrain the rising public debt, as well as that the Chinese authorities will continue to rely on fiscal stimuli to encourage economic activity (projected at 6.1% y-o-y in 2019), in an effort to stall negative external shocks going forward.

## Inflation movements

Inflation in the **euro area** slowed down from 1.4% y-o-y on average in Q2 to 0.9% y-o-y on average in Q3, and in September touched its lowest level in almost three years (0.8% y-o-y). The deceleration is primarily attributable to the y-o-y fall in energy prices and the lower contribution of unprocessed food prices. Though cost-push pressures from the labour market increased, the rise in unit labour costs in the prior period was mainly offset by lower profit margins, hence core inflation remained low (0.9% y-o-y on average in Q3). Inflation expectations were also lowered, primarily due to inflation being lower than anticipated and to weaker prospects for the euro area's economic growth. As for Serbia's main foreign trade partners, average y-o-y inflation, measured by the Harmonised Index of Consumer Prices, also slowed down in Q3 relative to Q2 – from 1.6% to 1.0% in **Germany** and from 0.9% to 0.3% in **Italy**. According to Eurostat's flash estimate, the euro area's y-o-y headline inflation slowed down additionally in October to 0.7%.

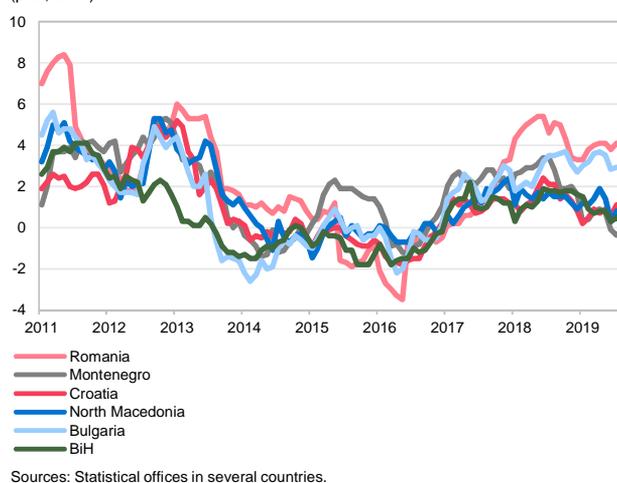
In most countries of **Central and Southeast Europe** inflation decelerated in Q3, mainly under the impact of lower contributions from the prices of food and energy. As for countries in our immediate surroundings, inflation ranged from -0.3% y-o-y in Montenegro to 3.8% y-o-y on average in Romania. Inflation in **Russia** continued down, from 5.0% y-o-y on average in Q2 to 4.3% y-o-y on average in Q3, amid weaker external and domestic demand. In **Turkey**, inflation also slowed down – from 18.0% y-o-y in Q2 to 13.6% y-o-y on average in Q3. To a great extent, this is attributable to the high base, as well as to the slower rise in energy prices and stabilisation of the Turkish lira. At the same time, single-digit inflation was recorded in September, for the first time since July 2017.

Measured by the personal consumption expenditure price index, average y-o-y headline inflation in the **USA** remained unchanged relative to Q2 and equalled 1.4% in Q3. Excluding food and energy prices, inflation rose from 1.6% y-o-y on average in Q2 to 1.7% y-o-y on average in Q3, meaning that it is still below the 2.0% target. With disinflationary pressures prevailing globally, inflationary pressures at home remained relatively low, despite positive labour market developments.

Chart IV.6.6 HICP across selected countries  
(y-o-y rates, in %)



Chart IV.6.7 Movement in the Consumer Price Index for selected countries  
(p.a., in %)



## Monetary policy

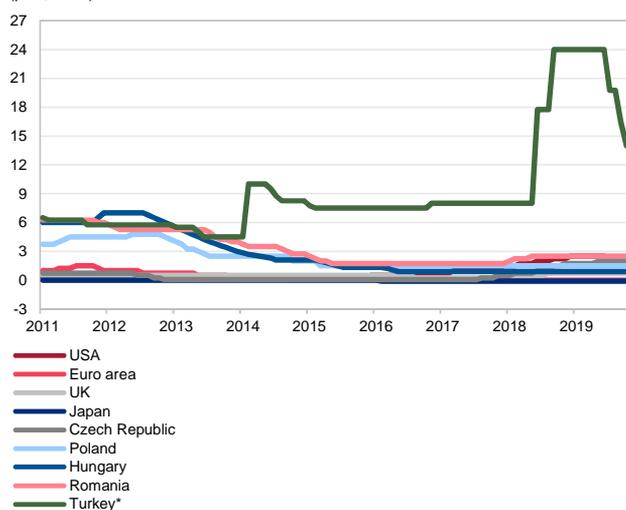
In its September meeting, the **ECB** trimmed its deposit facilities rate from -0.4% to -0.5% and changed its forward guidance, noting that, instead of at least through H1 2020, the rates are now expected to remain at their present or lower levels until the ECB has seen the inflation outlook converge to a level close to, but below 2%.<sup>27</sup> Also, a decision was made to restart net asset purchases at a monthly pace of EUR 20 bn starting from 1 November, and to end the purchases shortly before the ECB starts raising its key interest rates. Long-term bank lending within the TLTRO III programme will be disbursed under even more favourable conditions. Also, the ECB decided to introduce a tiering system for reserve remuneration, whereby two levels of banks' excess liquidity holdings are defined, effective as of 30 October 2019. The account following the meeting noted that a highly accommodative monetary policy will be required over a longer period to ensure that the inflation target is achieved. The October meeting confirmed decisions adopted in the September meeting.

In July, the **Fed** trimmed the federal funds target range for the first time since 2008, and then decreased it by another 25 bp in September, as well as in October, bringing it to 1.50–1.75%, in accordance with expectations. It was underlined that the US economic activity is rising at a moderate pace, with a low unemployment rate, citing the negative impacts of global developments on US economic prospects and dampened inflationary pressures as reasons for cutting the federal funds rate.

Rising disinflationary pressures from the external environment, coupled with new ECB and Fed measures, helped the majority of central banks in the region retain favourable monetary conditions.

As expected by analysts, the central bank of **Hungary** kept its key policy rate at 0.90% and its overnight deposit facility rate at -0.05%. However, the September increase in excess liquidity provided for the financial system partly annulled its reduction in March and June this year. Though increased domestic demand and good labour market performance are driving inflation up, the contracted economic performance in the euro area gave rise to stronger external disinflationary pressures, hence risks to the projection were assessed as tilted to the downside. Although inflation is expected to remain above

Chart IV.6.8 Policy rates across selected countries (p.a., in %)



Sources: Central banks of selected countries.

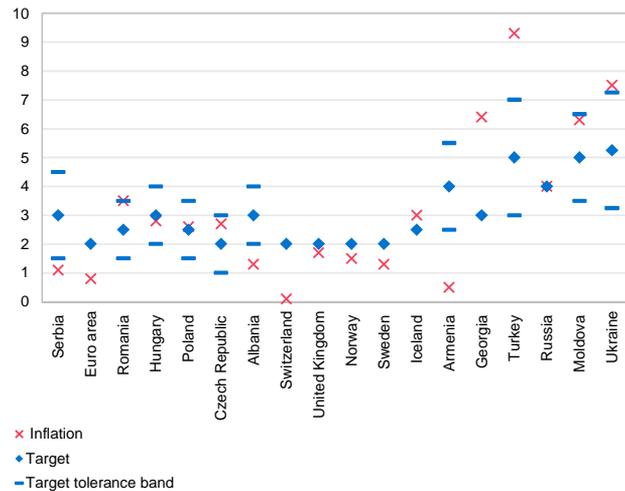
\* As of June 2018, after a year and a half, the one-week repo rate is again the key policy rate.

<sup>27</sup> See Text box 5 on page 50.

the target in the coming months, external factors drove the central bank of **Romania** to keep its key policy rate at 2.50% in Q3, in accordance with analysts’ expectations. As interest rates in Romania are much higher than in the euro area, monetary policy makers underlined that a higher rate might attract speculative capital. The central bank of **Poland** retained its key policy rate at 1.50% in Q3, where it has stood since March 2015. Officials noted that they see no need to change the rate any time soon. The **Czech** central bank also kept its key policy rate unchanged at 2.00% in Q3; however, in a September meeting risks to inflation projection were assessed as skewed to the upside.

During Q2, the central bank of **Turkey** trimmed the key policy rate by a total of 750 bp and then by another 250 bp in October, to 14.0%, against the backdrop of weaker cost-push pressures and a global downturn. In Q3, the central bank of **Russia** trimmed its key policy rate by a total of 50 bp and an additional 50 bp in its October meeting, to 6.50%, due to lower-than-expected economic growth and increased risks of a global slowdown. At the same time, it reiterated the possibility of further key policy rate cuts at one of the upcoming meetings.

Chart IV.6.9 Inflation and target by country in September 2019 (p.a., in %)



Sources: Eurostat and websites of central banks.

### Text box 5: ECB and Fed's new monetary policy measures and their potential impact on Serbia

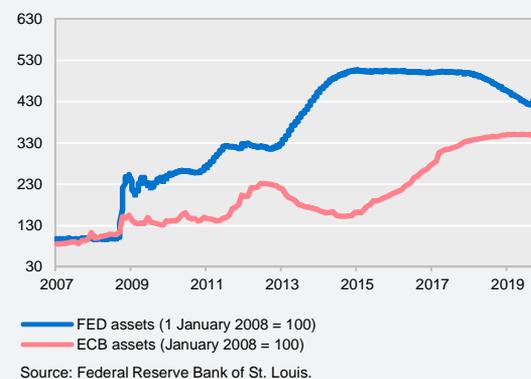
The turn in the monetary policies of leading central banks, the ECB and Fed, which took place around mid-year, alleviated the pressure on central banks of emerging economies towards monetary policy tightening and, in some cases, created room for trimming their key policy rates. Meanwhile, in the period since the previous Report, new measures were adopted aimed at further monetary policy easing by the ECB and Fed.

A set of new measures which the ECB adopted at the September meeting aims to provide a significant monetary stimulus to ensure that financial conditions in the euro area remain extremely favourable, as well as to support euro area growth and, in turn, the further strengthening of inflationary pressures at home and sustainable convergence of inflation towards the target. Bearing in mind the downward revision of the inflation projection, as well as the risk that inflation expectations would remain below the target for an extended period, the ECB stated the importance of demonstrating its determination and capacity to act by adjusting its instruments to achieve the inflation target. As stated in the account of the monetary policy meeting, the adopted measures have a synergetic effect, are complementary and mutually supportive, and act via a series of mechanisms. The deposit facility rate cuts and changes in forward guidance should be mirrored in declining interest rates along the entire yield curve, especially its short to medium-term segments. Reinforced forward guidance which signals the future path of interest rates – the main monetary policy instrument to which all other instruments are tied, such as net asset purchases and reinvestments – is considered a core element of the new package, because the “lift-off” date for interest rates will be state-dependent and directly conditional on the inflation projection. More specifically, interest rates would remain at their present record-low or even lower levels until projected inflation is seen to not only converge but also stabilise around a level sufficiently close to, but below 2% during the projection horizon. Given that achieved and projected inflation is currently far below the target level, the ECB intends to ensure measures that would be stimulating enough and result in a more significant rise in achieved and projected inflation. In addition, it was stated that interest rates can even be at lower levels, should the need arise. Still, the ECB noted that a more significant support of fiscal policy is necessary in countries where there is room for this policy to be more expansionary.

An important supplement to the interest rate policy is the renewed asset purchases programme, which has a greater influence on long-term interest rates and thereby on the reduction of corporate and household financing costs. The duration of the programme is dynamically adjusted to forward guidance – it will end shortly before the ECB starts increasing its interest rates. The ECB estimates that, under present conditions, combining the short-term interest rate policy with the new asset purchase programme ensures that these instruments are deployed in the most efficient manner and prevents excessive reliance on only one of them, given that each instrument has its limitations and that the impact of each individual measure is uncertain and hard to assess. As for the reinvestment policy, the revised forward guidance on policy rates would pass through to the reinvestment horizon, since reinvestments would continue even after the increase in interest rates and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary adjustment.

At the September meeting, the terms of the TLTRO III programme were also changed to ensure even more favourable bank funding conditions<sup>1</sup> in an environment of weak growth, which would ensure the continuation of favourable lending

Chart O.5.1 FED and ECB assets  
(weekly data, January 2008 = 100)



<sup>1</sup> Long-term bank loans within the TLTRO III programme will be disbursed at an interest rate fixed to the rate of main refinancing operations, i.e. to the deposit facility rate for banks that meet certain conditions. In comparison with the previous decision, the 10 bp spread has been removed, and the maturity extended from two to three years.

conditions to corporates and households. Prolonging the programme to three years should better align the operations with the typical maturity of bank-based financing of investment projects, thereby enhancing the support this programme provides to economic growth.

Finally, the introduction of a tiering system for banks' excess liquidity holdings<sup>2</sup> should help preserve the positive effects of the negative rate policy on the real economy by mitigating the direct cost for banks of holding excess reserves, thereby securing the smooth functioning of the monetary policy transmission mechanism.

Having trimmed the federal funds rate in its July meeting for the first time since 2008, the Fed lowered it again in the two subsequent meetings by a total of 75 bp, to 1.50–1.75%. The Fed's decisions on rate cuts had been anticipated by the majority of the market and their effects have already been largely incorporated in the decisions of market players. Some Fed officials stressed that the turn in the Fed's monetary policy in June, though without any rate cuts, had a much greater effect than the actual rate cuts, as it was suggested back then that future rate cuts are guaranteed (contrary to projections from end-2018 which hinted at additional rate hikes). What is certain is that the low interest rate environment will last longer than initially anticipated. Yet, it should be borne in mind that FOMC members have greatly differing views and that market expectations are significantly different to the Fed's projections.

Mid-September saw a volatility in the US money market, which is an important part of the transmission mechanism, as well as a steep rise in interest rates, with the effective policy rate overshooting the upper bound of the Fed's target range for the first time since 2008. Though decreased liquidity in the money market was anticipated, based on the quarterly tax collection and netting of Treasury auctions, the intensity of the reaction of short-term interest rates (overnight repo rates and the federal funds rate) was stronger than anticipated and exceeded the bounds of recent experiences. To alleviate the pressures in the money market, the Fed intervened by conducting a series of repo operations which, though usual for the pre-crisis period, have not been deployed for more than ten years. Analysts agree in their assessment that a disturbance in the money market would not jeopardise the central bank's ability to achieve its goals; however, they also indicate that decreased liquidity in the money market signalled that banks need a higher level of reserves which have not posed an issue for quite some time owing to quantitative easing, i.e. the fact that by purchasing securities the Fed secured a high level of liquidity.

Although a string of factors led to instability in the money market, it became clear that without a sufficient level of reserves in the system even a slight spike in liquidity demand could trigger major reactions in short-term interest rates, reflecting negatively on the monetary policy transmission mechanism. As stated in the press release from early October, the Fed decided to start buying US Treasury bills, adding that the purchases will extend at least into Q2 2020 in order to secure a sufficient level of reserves, at least equal to that in early September. This would ensure that control over the benchmark interest rate is performed mainly through interest rates determined by the Fed, and not through frequent market interventions. It also stated that the Fed would continue with term and overnight repo operations at least through January 2020. The Fed Chairman underlined that the increase in the Fed's assets is aligned with the March plan of monetary policy normalisation, which stated that at one point the Fed would begin increasing their security holdings in order to keep up with the increase in its other liabilities and maintain an adequate level

Chart O.5.2 Fed and ECB's\* expected key interest rates and 3-month EURIBOR futures (p.a., in %)



Sources: Fed, ECB and Bloomberg.

\* ECB Survey of Professional Forecasters (SPF).

<sup>2</sup> The first tier of excess liquidity holdings will be exempt from the negative interest rate, i.e. the rate will be 0%, while the second tier will continue to be remunerated at the deposit facility rate or at zero percent, whichever is lower. The size of the first tier will be determined relative to the level of reserve requirements, while the multiplier will be the same for all institutions and is currently set at 6. According to some analysts, the exemption of a part of excess liquidity holdings from the negative interest rate could increase the pressure on interest rate growth in the interbank market, which can explain the futures-based increase in market expectations of the three-month EURIBOR from end-October relative to end-July expectations.

of reserves, noting that the time has now come for such a move. Moreover, he underscored that the increase in the balance sheet should not be confused with the programme of large-scale asset purchases which began after the financial crisis, given that the recent disturbance in the money market was a technical issue and that Treasury bill purchases, which aim to remove the disturbance, should not have a major influence on the monetary policy stance.

#### **What is the effect of these measures on emerging markets, including Serbia?**

The Fed and ECB's monetary policy accommodation affects emerging markets, Serbia included, through the following channels:

– **Trade channel**, i.e. higher demand for import from emerging markets due to demand incentives in the euro area and the USA. Encouraging growth in the euro area, Serbia's key trade partner, should translate through the external demand channel into higher exports, thus contributing to the rise in Serbia's GDP.

– **Interest rate channel** – measures adopted by the ECB should also reflect on the lower costs of repaying the current euro-indexed loans in Serbia and the lower cost of new borrowing. The interest rate costs under previously disbursed foreign loans should also be lower. This can be conducive to growth in the disposable income of corporates and households and the rise in new investment financing.

– **Signalling channel**, i.e. higher investor readiness to invest in emerging economies. The prospects of Fed's further monetary policy accommodation represent a strong counterfactor to a possible deterioration of investor sentiment due to uncertain trade policies of leading economies and the global downturn.

– **Portfolio investment channel**, i.e. higher portfolio inflows to emerging markets. The situation is now different than a year ago, when heightened trade tensions were accompanied by expectations of the Fed tightening its monetary policy and when the capital inflow decreased, as did the outflow to a number of emerging markets, notably the most vulnerable ones. A turn in the Fed's monetary policy and the ECB's more expansionary monetary policy should alleviate the pressure on emerging economies. On these grounds, we can anticipate increased investor readiness to accept lower yields. Nevertheless, caution is still needed bearing in mind investors' greater exposure to emerging markets, which makes this category of investor assets more vulnerable in case the market sentiment deteriorates.

– **Exchange rate channel** – monetary policy easing by leading central banks should work towards strengthening the currencies of emerging economies. Changes in the relative prices of domestic and foreign goods affect the change in operating expenses, as well as the demand for domestic and import goods. However, the direction and intensity of these changes depend on a number of factors, including the extent of price rigidity, the strength of the exchange rate pass-through and the share of foreign trade conducted in the currency against which the domestic currency has strengthened.

Thanks to domestic factors – the achieved and maintained price stability and relative stability of the exchange rate, overall macroeconomic and financial stability, as well as improved business conditions, Serbia will remain attractive for long-term investments. This, together with the increased export supply, will help maintain a high export rate going forward. In addition, FX reserves, which rose to EUR 13.3 bn at end-September, have boosted Serbia's resilience to risks emanating from the international environment.

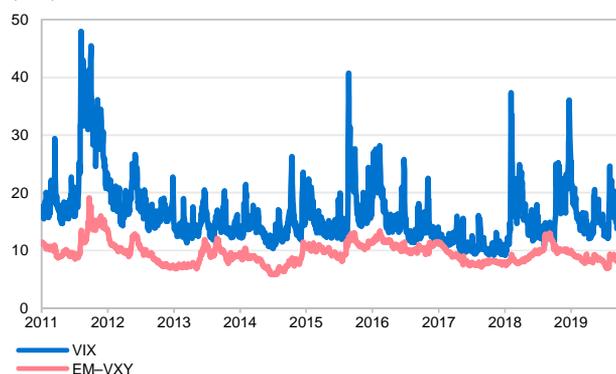
## Financial and commodity markets

The exacerbation of the US-China trade tensions in August reflected on the increased volatility in financial markets. However, once the trade talks continued, with expectations of additional monetary policy accommodation by leading central banks, the volatility gradually decreased. Hence, the implicit measure of **financial market volatility** (VIX) changed only slightly q-o-q (up 1.2 pp to 16.2% at end-Q3), as did the volatility of emerging countries' currencies, measured by EM-VXY, dipping 0.1 pp to 8.2%. In October both measures were trimmed – VIX by 3.0 pp and EM-VXY by 0.1 pp.

The August announcement of new US tariffs on Chinese imports and the ensuing poorer outlook of global economic growth resulted in a further decline in **yields on government bonds** of advanced countries. As trade talks progressed and chances of a no-deal Brexit decreased, bond yields increased to a degree, but remained far below the level from end-H1, and in some cases did not leave the negative territory. Hence, in Q3, yields on ten-year German government bonds fell by 0.2 pp to -0.6%, and on benchmark French and Austrian bonds by 0.3 pp each, to -0.3%. In August, for the first time, the entire yield curve of German government bonds was in the negative zone, where it still remains. Looking to make profit, investors purchased bonds of peripheral euro area countries, therefore their yields also declined, mostly those on Italian (by 1.3 pp to 0.8%) and Greek ten-year bonds (by 1.1 pp to 1.3%). Yields on ten-year US Treasuries contracted from 2.0% at end-H1 to 1.7% at end-Q3, however the spread between these and three-month US Treasuries became positive in early October, thus slightly alleviating fears of recession. During October, yields on ten-year US Treasuries did not change significantly, while in the majority of European countries they rose mildly.

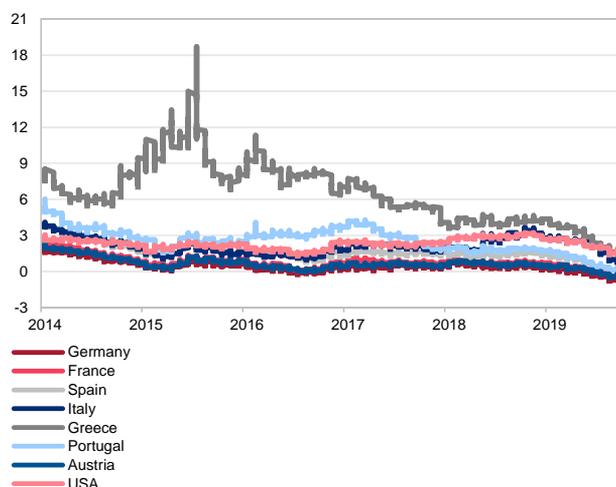
Observed at the end of the period, all major global currencies weakened against the **dollar**. According to analysts, despite an economic downturn in both the USA and the euro area, a slightly improved US inflation outlook is making it difficult for Fed to signal an extended period of greater monetary policy easing, unlike the ECB which has already indicated that a very accommodative monetary policy will be needed for a longer period. This was mirrored by the **euro weakening** 4.3% in Q3 **against the dollar**. Uncertainty surrounding Brexit resulted in a weaker British pound (by 3.0% in Q3). After accelerating in H1, the Russian rouble, Swiss franc and Japanese yen also depreciated against the dollar (by 2.4%, 2.1% and 0.3% respectively). In October, most of the leading currencies regained some of their value relative to the dollar. Amid low, and even negative bond yields, as well

Chart IV.6.10 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.6.11 Yields on ten-year bonds of selected countries (daily data, in %)



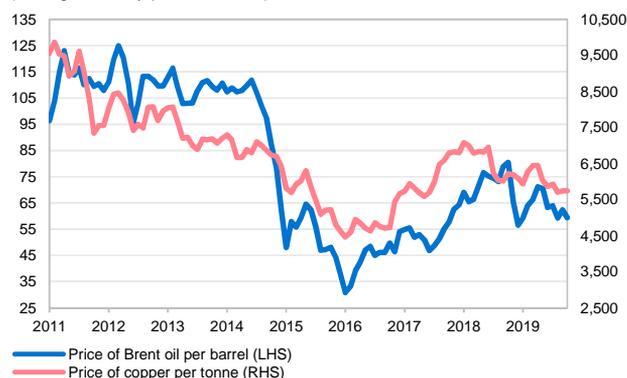
Source: Bloomberg.

Chart IV.6.12 Exchange rates of selected national currencies against the dollar\* (daily data, 31 December 2013 = 100)



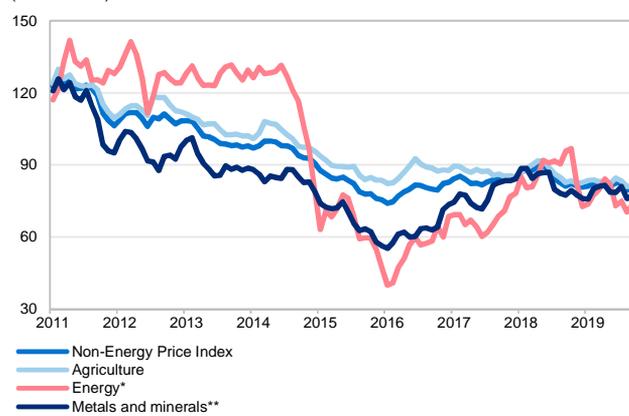
Source: IMF.  
\* Growth indicates appreciation.

Chart IV.6.13 Oil and copper price movements  
(average monthly prices, in USD)



Source: Bloomberg.

Chart IV.6.14 Primary Commodity Prices Index  
(2010 = 100)

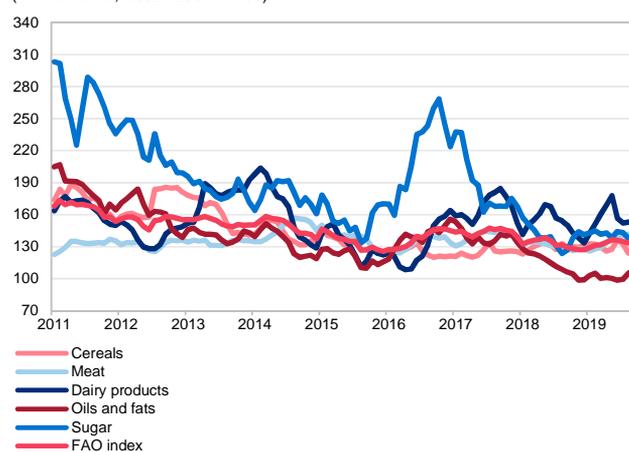


Source: World Bank.

\* Crude oil, natural gas and coal.

\*\* Copper, aluminium, iron ore, lead, nickel, zinc, copper and tin.

Chart IV.6.15 World Food Price Index  
(in real terms, 2002–2004 = 100)



Source: UN FAO.

as rising prices of shares, the **price of gold** continued up, gaining 5.4% in Q3 and an additional 1.7% in October.

The **global oil price** was volatile in Q3. At end-September it was 7.1% lower than at end-H1, equalling USD 59.9 per barrel. At the start of the quarter, the oil price declined under the impact of weaker global outlook and record-high production in the USA. After declining to USD 57 per barrel in August, the price of oil jumped to almost USD 70 per barrel in mid-September in the wake of attacks on oil processing facilities in Saudi Arabia. However, as this had a short-term effect on production, concerns over global growth and the consequently poorer oil demand outlook prevailed again. The fall in the oil price at end-September was additionally facilitated by the dollar gaining against other global currencies. The price of oil stayed relatively stable throughout October, ending the month at USD 59.6 per barrel.

Due to a global downturn, declining business confidence and concerns over global growth, the **prices of metals and minerals** continued to decline. According to the World Bank's index of primary commodity prices, the prices of metals and minerals contracted by 1.5% in Q3. Following robust growth since the start of the year onwards, the price of the iron ore contracted 14.6% in Q3 as Brazil's export recovered, while the increase in inventories contributed to a further decline in the price of copper (2.1% in Q3). Conversely, the price of nickel soared in Q3 (47.8%) due to a ban on nickel export from Indonesia, effective as of 2020, two years sooner than previously expected.

Measured by the **FAO index**, and after rising in H1, world food prices decreased 1.9% in Q3. The largest dip was recorded in the prices of cereals (9.1%), largely amid prospects of the USA, the world's largest corn producer and exporter, having a much better corn harvest than previously expected. The prices of sugar also declined, by 8.3% in Q3, due to the expected high inventories on account of good production prospects going forward, while the prices of dairy products also declined – by 2.9%. In contrast, of all food products in the FAO index, the prices of vegetable oil went up (8.2%) and in September reached their maximum level in more than a year, mainly on account of the recovered global demand for palm oil. The increase in meat prices, which began in February, continued in Q3, when these prices rose 2.9%, i.e. 11.8% since the start of the year. This was mostly facilitated by the increase in the price of pork due to the high import demand from China, to offset the fall in domestic production caused by the African swine fever. According to a European Commission report, the prices of pork in the EU have been rising on this account since mid-March and are currently at their highest level since September 2013.

## V Inflation projection

According to the November central projection, by the end of 2019 and in H1 2020 inflation is expected to move around the lower bound of the target tolerance band, reflecting mainly the high base effect of vegetable prices. In the period thereafter, the base effect of vegetable prices will work in the opposite direction, which will, together with the expansion in aggregate demand and the expected pick-up in administered price growth, lead to inflation's gradual approaching the target midpoint by the end of the projection horizon. Uncertainties surrounding the inflation projection are associated primarily with developments in the international commodity and financial markets and, to an extent, to administered price growth. On the whole, risks to the projection are judged to be symmetric.

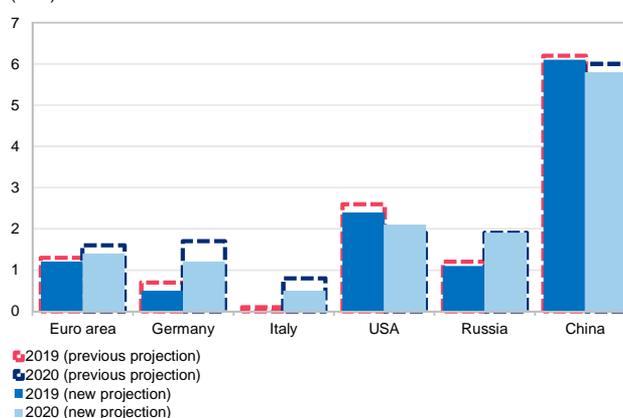
We revised the 2019 GDP growth forecast upward to 3.6%, since domestic factors in the year to date successfully compensated for lower external demand. Investment growth has been mostly spurred by the continued implementation of infrastructure projects, improvement in the business environment and favourable sources of private sector financing, while household consumption rose on the back of positive labour market trends. GDP growth is expected to pick up to around 4% in 2020 and maintain similar dynamics in the medium-term, led by investment, exports and a sustainable rise in household consumption. Medium-term risks to the GDP projection are judged to be symmetric – those stemming from the international environment are judged to be tilted to the downside and those from the domestic environment to the upside.

### Inflation projection assumptions

#### External assumptions

International developments have been under the sway of the **slowdown in global trade and economic growth**, as well as additional accommodative measures of leading central banks aimed at alleviating the negative effects of growing protectionism and uncertainty. The IMF<sup>28</sup> again revised down its projection of global growth, to 3.0% for this year, the lowest figure since the global economic crisis. Relative to the July projection, growth was reduced by 0.2 pp. In 2020, the IMF expects a moderate improvement and expansion of the global economy by 3.4%, 0.1 pp lower compared to July. The main reasons for the downward revision are the rising trade barriers, rising uncertainties in the trade and geopolitical sphere, specific factors causing macroeconomic tensions in several emerging economies and structural factors such as low productivity growth and demographic changes in advanced economies due to the higher average age of the population.

Chart V.0.1 IMF's revised forecast for real GDP growth for 2019 and 2020 (in %)



Sources: IMF WEO (October 2019) and IMF WEO Update (July 2019).

<sup>28</sup> World Economic Outlook, October 2019.

Table V.0.1 Key projection assumptions

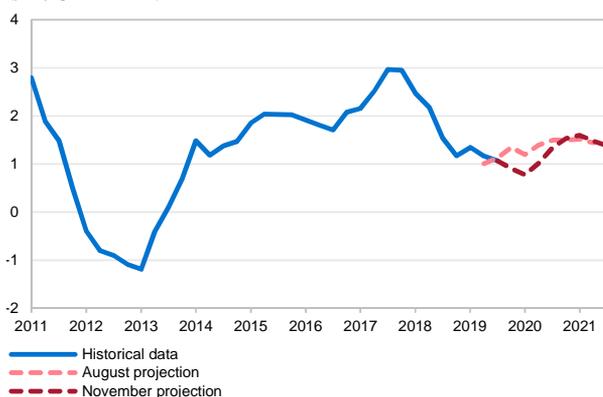
	2019		2020		2021	
	Aug.	Nov.	Aug.	Nov.	Aug.	Nov.
<b>External assumptions</b>						
Euro area GDP growth	1.2%	1.1%	1.4%	1.2%	1.4%	1.4%
Euro area inflation (annual average)	1.3%	1.2%	1.4%	1.0%	1.6%	1.5%
ECB policy rate*	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%
International prices of primary agricult. commodities (Q4 to Q4)**	-3.0%	-7.0%	3.1%	7.3%	2.5%	5.6%
Brent oil price per barrel (December, USD)	63	61	60	57	59	56
<b>Internal assumptions</b>						
Administered prices (Dec. to Dec.)	3.7%	3.4%	4.0%	3.7%	4.0%	4.0%
<b>Trends</b>						
Appreciation trend of the real exchange rate (average)	0.3%	0.3%	0.4%	0.4%	0.5%	0.5%
Real interest rate trend (average)	0.2%	0.2%	0.0%	-0.1%	0.0%	0.0%

\* ECB Survey of Professional Forecasters.

\*\* Composite index of soybean, wheat and corn prices.

Sources: NBS, ECB, Euronext, CBOT and Bloomberg.

Chart V.0.2 Assumption for euro area GDP growth (y-o-y growth, in %)



Sources: ECB, Consensus Forecast and NBS calculation.

Table V.0.2 Economic growth estimate by country (real growth, in %)

	July 2019		October 2019	
	2019	2020	2019	2020
Poland	4.3	3.4	4.3	3.5
Czech Republic	2.5	2.4	2.6	2.2
Hungary	4.2	3.0	4.6	3.1
Albania	3.6	3.3	3.4	3.3
Bulgaria	3.3	3.0	3.4	2.9
Bosnia and Herzegovina	3.1	3.1	2.7	2.7
North Macedonia	3.0	3.1	3.2	3.1
Romania	3.8	2.9	4.1	3.0
Slovakia	3.5	3.1	2.8	2.6
Slovenia	3.3	2.8	2.9	2.7
Croatia	3.0	2.5	2.9	2.5

Source: Consensus Forecast.

According to the IMF's assessment, growth would have been even lower in both years (by 0.5 pp), had it not been for monetary stimuli of leading central banks. As opposed to a rather synchronised slowdown in global growth, the IMF expects uneven recovery. Growth of advanced economies is projected at 1.7% in both 2019 and 2020 and of emerging economies at 3.9% and 4.6%.

As for the **growth in the euro area**, our most important trade partner, our current projection is adjusted in line with the September projection of the ECB. According to the ECB, real GDP growth of the euro area will decelerate to 1.1% in 2019, only to gradually pick up to 1.2% and 1.4% in 2020 and 2021. Compared to the previous projection, this year's growth was revised down by 0.1 pp, in view of the indicators suggesting that the expected recovery in the second half of the year will be delayed, especially in industrial production. The growth forecast for 2020 was reduced by 0.2 pp, mostly due to the carry-over effect, while there were no changes for 2021. The growth outlook was aggravated mostly due to sluggish global trade amid the persisting uncertainty over growing protectionism, which negatively affects manufacturing. The service sector, oriented toward the domestic market, as well as construction, show greater resilience, while the labour market has seen further improvement. The new ECB's projection incorporates lower interest rates, a lower oil price, reaching of the Brexit deal and fiscal relaxation in the period ahead, which should help the euro area bounce back to its medium-term trend. The Consensus Forecast also expects euro area growth of 1.1% in 2019, same as they did three months ago, while their expectations for 2020 were revised down again, only more sharply this time, by 0.3 pp to 0.9%. The IMF has been somewhat more optimistic, though they reduced their euro area growth forecast for this and the coming year to 1.2% and 1.4%.

When it comes to our key **trade partners in the euro area**, compared to the forecast from three months ago, the Consensus Forecast again reduced **Germany's** growth outlook for this and next year, by 0.2 pp and 0.6 pp – to 0.5% and 0.8%. The main reasons quoted for the reduction are the unfavourable leading indicators of economic activity, primarily the manufacturing PMI, which signalled the shrinking in new orders and production in September, to the lowest level in more than ten years. Export-oriented Germany undoubtedly feels the consequences of global trade weakening, apart from facing challenges in the automobile industry, so there are increasing proposals from the business community, and from EU officials, urging for fiscal stimuli, especially in view of Germany's fiscal surplus recorded for the fifth consecutive year. The growth forecast for **Italy**, slightly

stronger for 2019 than three months ago (0.1% relative to 0.0%), and unchanged for 2020 (0.4%), reflects the opinion of Consensus Forecast respondents that the Italian economy will not make a major recovery after all, due to the uncertainties in the international environment and weak domestic demand. The IMF revised its growth forecast for Germany to 0.5% in 2019 (previously: 0.7%), and 1.2% in 2020 (previously: 1.7%). Italy's growth was also adjusted downward to 0% (previously: 0.1%) and 0.5% (previously: 0.8%), in this and next year.

As opposed to euro area economies, **the expected growth of countries in our region**, which are also our important trade partners, underwent no significant downward revisions. According to the Consensus Forecast, the expected growth in **Southeast Europe**<sup>29</sup> in 2019 **has not changed relative to the forecast from three months ago** (3.5%), while the forecast for 2020 saw a mild revision, down by 0.1 pp to 2.8%. The growth forecast for **Central Europe**<sup>30</sup> of 3.8% and 3.1% in this and next year remained unchanged relative to July. However, there are some differences country-wise. On the one hand, Slovakia saw the sharpest downward revision (by 0.7 pp and 0.5 pp in 2019 and 2020, respectively), due to the manufacturing industry's high export dependence and the sluggish growth of the country's main trade partners. Bosnia and Herzegovina and Slovenia also saw downward revisions for both years. On the other hand, some forecasts were improved, primarily for Hungary and Romania, which continued to largely rely on domestic demand in order to compensate for the softening of external demand. The ECB's and Fed's monetary policy accommodation should reflect favourably on all countries in the region, primarily owing to continued favourable external financing conditions.

**Inflationary pressures remain low in most advanced economies** and projected inflation continues to move below the central bank targets throughout the projection horizon. Our projection operates under the assumption that **euro area inflation will** move in line with the ECB's October projection, according to which it will remain low this and next year (1.2% and 1.0%), only to rise in 2021 to 1.5%. Compared to its previous projection, the ECB made the sharpest downward revision in 2020 inflation – by 0.4 pp, and by 0.1 pp both in 2019 and 2021. The main reason for the ECB's revision is the expected decline in global oil prices.<sup>31</sup> Professional

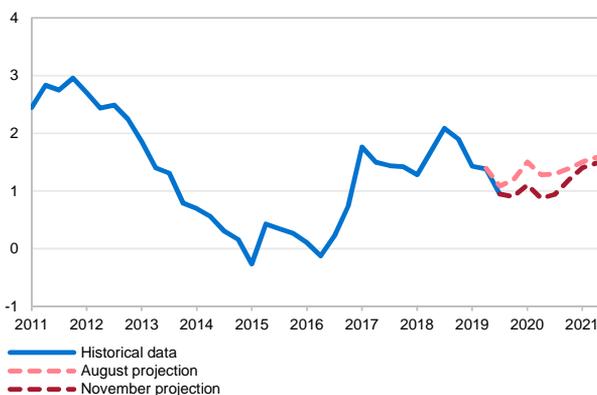
Table V.0.3 Inflation estimate by country  
(annual average, in %)

	July 2019		October 2019	
	2019	2020	2019	2020
Poland	2.1	2.7	2.3	2.9
Czech Republic	2.6	2.1	2.8	2.3
Hungary	3.4	3.2	3.4	3.2
Albania	1.9	2.1	1.8	2.1
Bulgaria	3.0	2.7	2.9	2.7
Bosnia and Herzegovina	1.5	1.7	1.3	1.6
North Macedonia	1.8	2.1	1.6	2.0
Romania	3.9	3.2	3.9	3.3
Slovakia	2.5	2.3	2.6	2.3
Slovenia	1.6	1.7	1.7	1.7
Croatia	1.0	1.6	0.9	1.4

Source: Consensus Forecast.

Chart V.0.3 Assumption for euro area inflation

(y-o-y growth, in %)



Sources: ECB, Consensus Forecast and NBS calculation.

<sup>29</sup> Albania, Bosnia and Herzegovina, Bulgaria, Croatia, North Macedonia, Romania and Serbia.

<sup>30</sup> The Czech Republic, Hungary, Poland, Slovakia and Slovenia.

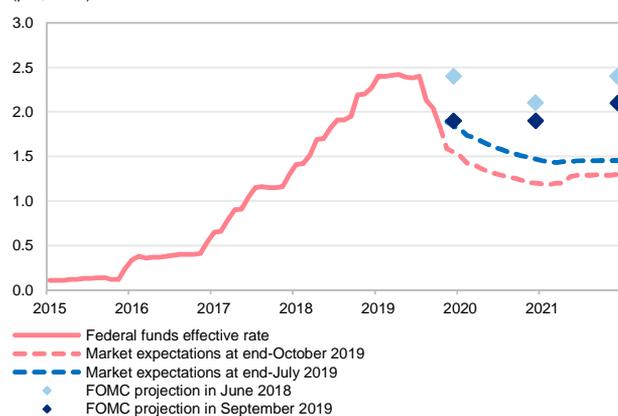
forecasters also anticipate lower inflation in the euro area in the coming period.<sup>32</sup> According to the October ECB's survey, professional forecasters again lowered their expectations (by 0.1 pp for each year), expecting the inflation rate of 1.2% in this and next year and of 1.4% in 2021. Apart from the data on lower than expected inflation in the period from the previous survey, the revision was motivated by lower global oil prices and weaker economic growth prospects. According to the Consensus Forecast, expected inflation in the euro area is also lower than three months ago – measuring 1.2% in this and next year.

**Major inflationary pressures are not expected in countries of the region either.** In these countries, inflation should be mainly determined by economic and wage growth on the one hand and subdued imported inflation on the other. In October, the Consensus Forecast revised up their inflation projection for **Southeast Europe** relative to July – by 0.4 pp to 3.4% for 2019, and by 0.5 pp to 3.2% for 2020. The Consensus Forecast also increased their inflation projection for Central Europe for this and next year, but less sharply (by 0.1 pp each), to 2.5% and 2.7 %.

In conditions of low inflationary pressures, leading central banks responded by further accommodation, in order to mitigate the negative effects of trade tensions on economic growth. **Key policy rate trajectories of leading central banks** underwent another downward revision. In September and October, **the Fed** cut down its federal funds rate by 25 bp each (to 1.50–1.75%), due to the negative impact of global movements on the US economic prospects and low inflationary pressures. The Fed also signalled readiness to take more substantial measures should there be any weakening signs from the US economy. Judging by the futures, the market anticipates further policy rate cuts – the expected federal funds rate trajectory at end-October is lower than in our previous projection.

When it comes to **financial conditions in the euro area**, which is also Serbia's most important financial partner, our projection assumption is consistent with the ECB's announcements that conditions will be more favourable than we assumed in the previous projection. The ECB's September package of measures is the most generous in the past three years: the deposit facility rate, already in the negative territory, was cut down further and the

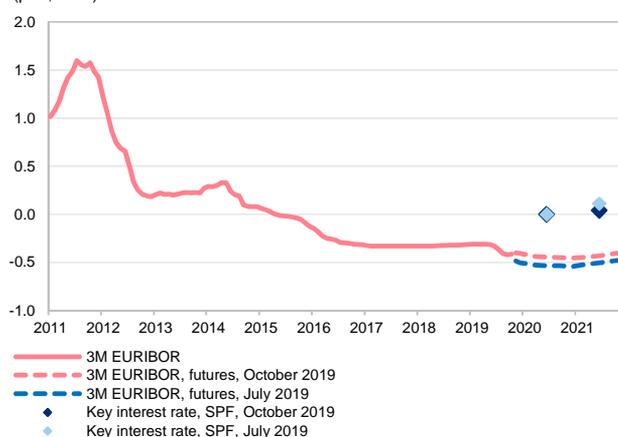
Chart V.0.4 Expected Fed funds rate\*  
(p.a., in %)



Sources: Fed and Bloomberg.

\* Futures-based market expectations.

Chart V.0.5 Expected ECB interest rate\* and 3M EURIBOR futures  
(p.a., in %)



Sources: ECB and Bloomberg.

\* ECB Survey of Professional Forecasters (SPF).

<sup>31</sup> The previous, June projection of the ECB was concluded on 15 May, when the global oil price soared to over 70 dollars per barrel.

<sup>32</sup> ECB Survey of Professional Forecasters (SPF).

decision was made to restart the asset purchase programme. The ECB also signalled it was ready to go beyond this if necessary, to ensure the sustained convergence of inflation to the target in the medium term, while at the same time expecting more from fiscal policy. The ECB President highlighted the need for a fiscal policy response through tax reductions and higher spending, especially in the countries that are in the position to take such measures.

That ECB’s monetary accommodation will be stronger than anticipated three months ago is also expected by professional forecasters, which assessed in October that the ECB’s reference rate would not be raised in 2020, while their aggregate expectations for 2021 amounted to mere 0.04%. Our projection also rests on the assumption that the EUR/USD exchange rate will remain unchanged throughout the projection horizon, lingering at the average level in the last two weeks before the projection was finalised (EUR/USD 1.11). The expected new cycle of monetary policy accommodation should positively affect the conditions in the international financial market, capital flows to emerging economies and the stability of their FX markets.

Uncertainty in terms of future trends in the international environment relates to movements in **global primary commodity prices**. The major uncertainty stems from the global oil price, which soared in mid-September following the attacks on Saudi Arabia’s oil facilities, only to plummet to around USD 60 per barrel in October, or 26% below the average price from October last year. The relatively low oil price in the global market reflects the concerns that the sluggish global growth outlook might entail weaker demand. According to EIA assessment<sup>33</sup>, the global Brent oil price should average USD 59 per barrel in Q4 this year, and decline to USD 57 per barrel in Q2 2020. The EIA expects a mild bounce-back to USD 62 per barrel in H2 2020. The risks to the projection concern possible sudden disruptions in supply, which could trigger oil price hikes, but even more the slowing of global demand which would work in the opposite direction. It remains unknown to what extent the expected lower oil price would spark demand.

Consistent with early-November oil futures (taking into account the average of the last two weeks), the new projection assumes the global oil price of USD 61 per barrel in December 2019, and USD 57 and USD 56 per barrel in December 2020 and 2021, which is lower than our projection three months ago.

Chart V.0.6 Assumption for Brent oil prices (USD/barrel)

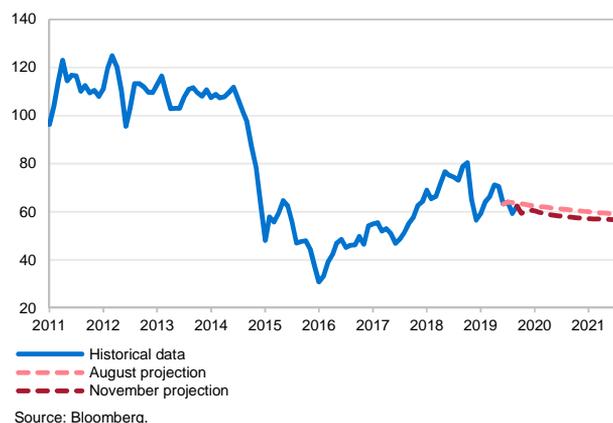


Chart V.0.7 Assumption for international prices of primary agricultural commodities (Q4 2013 = 100)

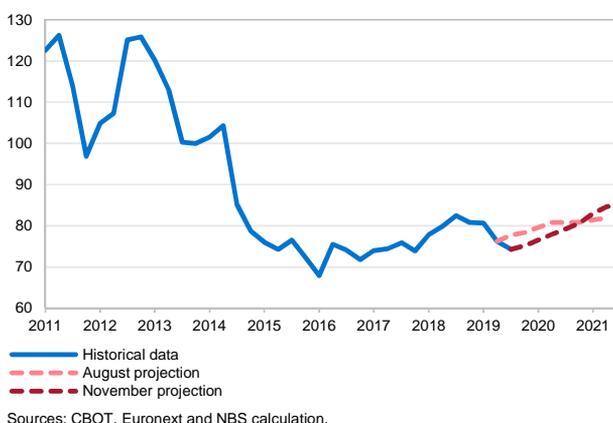
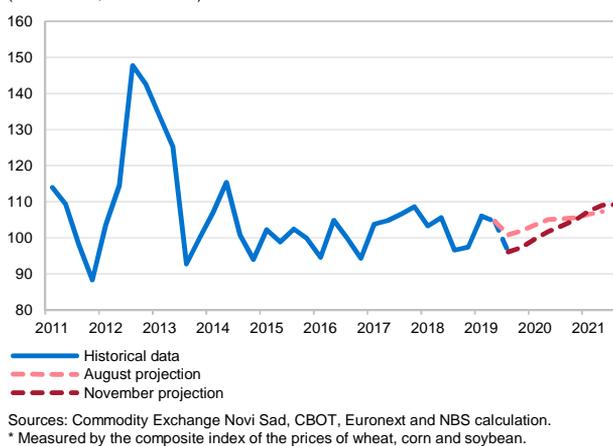
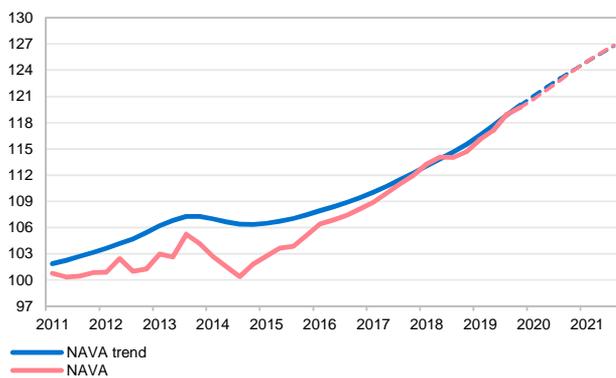


Chart V.0.8 Assumption for domestic prices of primary agricultural commodities\* (base index, 2013 = 100)



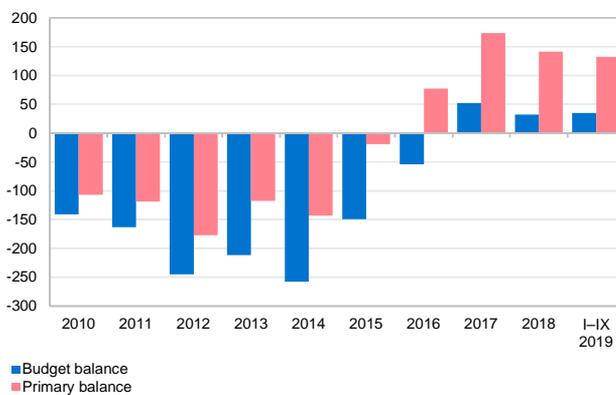
<sup>33</sup> U.S. Energy Information Administration.

Chart V.0.9 Output gap projection  
(Q3 2008 = 100)



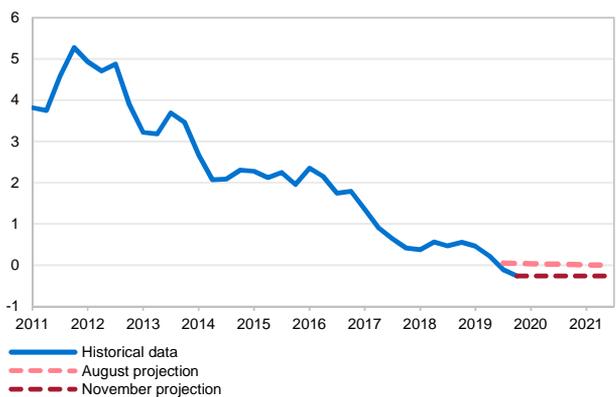
Sources: SORS and NBS calculation.

Chart V.0.10 General government fiscal and primary budget balance  
(in RSD bn)



Source: Ministry of Finance.

Chart V.0.11 Real interest rate trend  
(in %)



Sources: CBOT, Euronext and NBS calculation.

There is also uncertainty over movements in the global prices of other primary commodities, notably **metals** and **primary agricultural commodities**. The volatility of these prices reflects the growing influence of supply-side factors, as opposed to subdued global demand. When it comes to prices of primary agricultural commodities, which are of special importance for Serbia, our projection operates on futures data from Euronext Paris and the Chicago Board of Trade. Based on these data, we assumed a somewhat sharper fall of primary agricultural commodity prices in 2019 (-7.0%), followed by a somewhat stronger increase in 2020 and 2021 (7.3% and 5.6%) compared to the previous projection..

### Internal assumptions

**Primary agricultural commodity prices in the domestic market**<sup>34</sup>, as well as at the global level, declined in Q3, most notably wheat prices, after this year’s harvest. Consistent with our expectations from the previous *Inflation Report*, this pushed food production costs below the neutral level. Bearing in mind the movements of futures on the Paris and Chicago stock markets, we expect domestic prices of agricultural products in 2019 to be lower than last year and to decline more than assumed in the August projection. Consistent with futures movements, these prices are expected to be on the rise in the next two years.

**Administered price** growth since the start of this year was almost fully led by the cigarette price hikes due to higher excise duties and measured 2.3% in y-o-y terms in September. Bearing in mind the announced December increase in electricity prices of 3.9% y-o-y, administered price growth in this year will amount to 3.4%. The assumed growth for 2020 and 2021 is 3.7% and 4.0%, respectively.

In conditions of low cost-push pressures, **inflation expectations** are likely to remain stable until the end of the projection horizon. Bearing this in mind, as well as lower interest rates in the euro area and a lower country risk premium, **the real interest rate trend** throughout the projection horizon should stay lower than in the previous projection.

The projection operates on the assumption of a further growth in **aggregate demand**. In Q3, NAVA rose faster than its potential, hence the output gap was neutral. In the coming period, domestic demand is expected to expand

<sup>34</sup> Measured by the composite index of the prices of wheat, corn and soybean.

further, supported by the rise in private sector wages and employment, increase in public sector wages and pensions, past monetary policy easing by the NBS and the still relatively low interest rates in the euro area. Still, the assessed increase in spending will be slower than real GDP growth and will not fuel internal and external imbalances.

As a result of the full coordination of monetary and fiscal policy measures, successfully implemented fiscal consolidation and economic growth, 2019 has seen the continuation of favourable **fiscal trends**. Concluding with September, the general government recorded a fiscal surplus of RSD 35.1 bn and the primary surplus of RSD 131.9 bn, against the backdrop of much higher government capital expenditure and increased outlays for wages and pensions. Thanks to the elimination of fiscal imbalances, the share of central government public debt in projected GDP at end-September declined to 52.0% and its further downward trend is expected in the period ahead. According to the estimate of the Ministry of Finance, the fiscal policy stance is likely to be slightly expansionary in the coming period, without major pressures on inflation growth. This year's general government deficit is projected at 0.5% of GDP, i.e. the medium-term deficit target, which will ensure that the downward trajectory of public debt is maintained.

The balanced public finances and the firm downward trajectory of public debt, along with sustainable economic growth and low inflation, all reflect on the **lower country risk premium and the improved credit rating** now only a step away from the investment grade, which contributes to the **relative stability in the FX market and Serbia's increased resilience to the risks from the international environment**.

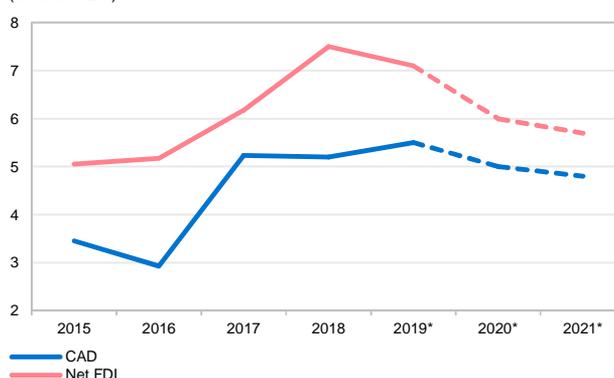
Goods and services exports should speed up in coming period, on the back of a high FDI inflow in tradeable sectors and the expected recovery of external demand. The import of equipment and intermediate goods is expected to increase owing to the continuation of the investment cycle, while the higher standard of living of citizens and consumer demand will contribute to the rising import of consumer goods. We estimate that the share of the current account deficit in GDP will be around last year's level, to gradually decline in the coming years. The FDI inflow is expected to reach the level from the previous year and, in net terms, more than fully cover the current account deficit for the fifth year in a row. This trend is likely to persist in the coming years as well.

Table V.0.4. **Estimate of fiscal trends in 2019–2022**  
(in % of GDP)

	Estimate	Projection		
	2019	2020	2021	2022
Public revenue	41.4	40.2	39.4	38.7
Tax revenue	36.5	35.8	35.4	34.9
Non-tax revenue	4.6	4.1	3.7	3.5
Public expenditure	41.9	40.7	39.9	39.2
Expenditure for employees	9.5	9.5	9.5	9.5
Pensions	10.4	10.2	10.0	9.8
Interests	2.1	1.9	1.7	1.6
Capital expenditure	4.4	4.5	4.6	4.7
Total balance	-0.5	-0.5	-0.5	-0.5
Primary balance	1.6	1.5	1.3	1.2

Source: Ministry of Finance.

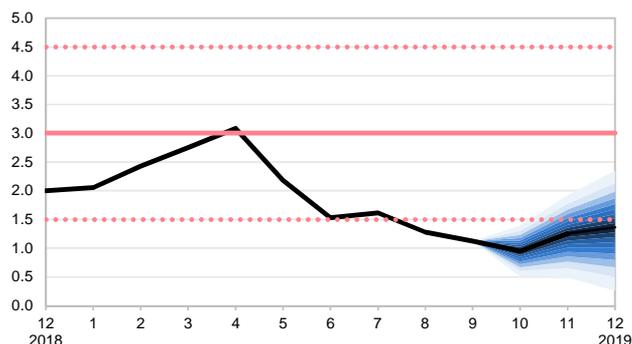
Chart V.0.12 **Current account deficit and net FDI inflow**  
(in % of GDP)



Source: NBS.

\* NBS projection.

Chart V.0.13 Short-term inflation projection  
(y-o-y rates, in %)



Source: NBS.

## Inflation projection

### Short-term inflation projection

Under the central projection for Q4, inflation is expected to hover around the lower bound of the target until the end of this year.

A mild rise in y-o-y inflation from the current 1.1% will be triggered by administered price growth, which will pick up from 2.3% y-o-y in September to 3.4% y-o-y in December 2019 after the planned adjustment of electricity prices. The expected rise in the contribution of petroleum product prices will work in the same direction, due to the low last year's base. On the other hand, due to low food production costs, lower contributions are also expected from processed and unprocessed food prices.

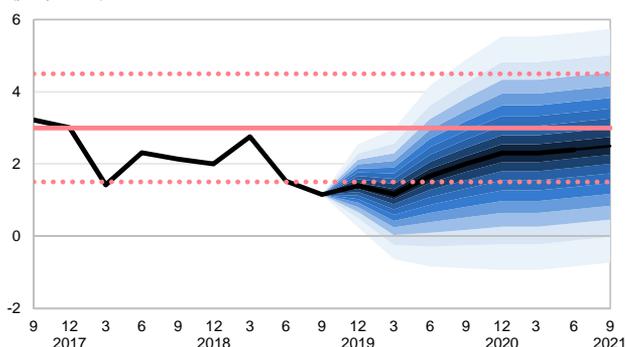
Same as before, key risks to the projection until the end of the year will continue to stem from fruit and vegetable prices, given their high volatility and impact on the pace of headline inflation.

### Medium-term inflation projection

Based on projection assumptions, we expect y-o-y inflation to move around the lower bound of the target until the middle of next year, whereafter it will gradually approach the target midpoint.

Same as in the previous projection, **aggregate demand** is expected to continue its growth, almost uninterrupted since end-2014. Since NAVA rose faster than its potential in Q3, the output gap was neutral and is likely to move in the positive territory until the end of the projection horizon. The negative output gap closed more quickly than we assumed in the previous projection, due to faster growth in domestic demand, supported by positive trends in the labour market, as well as by the increase in public sector wages and pensions, which positively impacted disposable household income. Disposable income also benefited from lower interest rates and hence, lower costs of loan repayment, which were brought about by the past monetary policy easing by the NBS. A positive effect also stems from low rates on euro-indexed loans, which should remain low longer than initially expected, given the announced stronger monetary accommodation by the ECB. Low interest rates will also be supported by the low country risk premium which recently fell below 50 bp, its historical low. On the other hand, the slowdown in the global economy and growth in the euro area, notably Germany and Italy, our key foreign trade partners, will bring about weaker external demand.

Chart V.0.14 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 outcomes 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%.

**Administered price** growth is likely to reach 3.4% this year, reflecting mainly the cigarette price adjustment in February and July and the announced rise in electricity prices, which did not take place last year. The contribution of administered price growth to inflation would thus be higher by 0.2 pp than last year. In 2020, administered price growth is expected to measure 3.7% and in 2021: 4%.

The **global oil price** edged down again relative to the previous projection, which led to a further reduction in petroleum product prices in the domestic market and their negative contribution to y-o-y inflation. As futures suggest that market participants expect the global oil price to be somewhat below its current level, the contribution of petroleum product prices to inflation in 2020 could stabilise around zero.

At the onset of this year’s agricultural season, **fresh vegetable prices** reduced their contribution to inflation growth (from 1.5 pp in April to -0.2 pp in September) to a greater extent than anticipated in the previous projections. These prices thus plunged below the neutral level, which should lead to their gradual growth in the period ahead. Still, fresh vegetable prices are likely to provide the lowest contribution to inflation in April next year, only to gradually pick up thereafter, with the onset of the new agricultural season.

Looking at the dynamics of primary agricultural commodity prices, we estimate that the **costs of raw materials in food production** will move slightly below the neutral level by the year-end. Thereafter, we expect a moderate rise in primary agricultural commodity prices and the return of costs of raw materials in food production to the neutral level, in accordance with the assumed movement in global primary agricultural commodity prices, given that global prices have the major impact on their domestic counterparts.

Given the expected movement in prices of primary agricultural commodities, which are important raw materials in processed food production (wheat, corn, soybean), we expect no upward pressures on **food inflation** on these grounds. What is more, the fall in the prices of primary agricultural commodities, especially wheat, in recent months, pushed down food production costs, which should slow down food inflation in the coming period, despite the gradual growth in unit labour costs. In the medium run, we expect its growth to be modest and led primarily by the gradual rise in aggregate demand and unit labour costs.

Chart V.0.15 RMCP and food prices (in %)

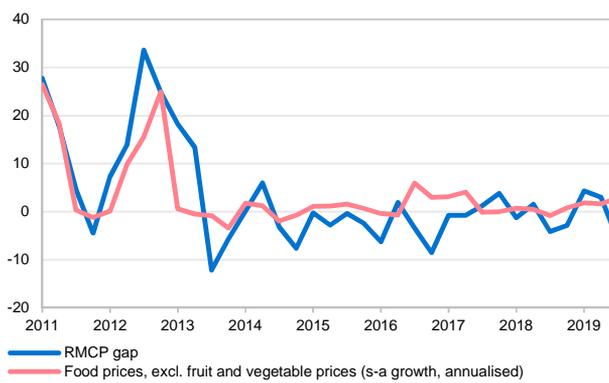
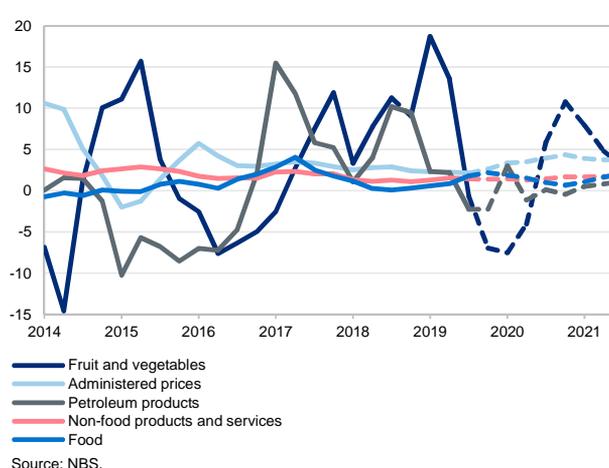


Chart V.0.16 Projection of inflation components (average y-o-y rate, in %)



A mild rise is also expected for **non-food inflation**, led by rising aggregate demand. Non-food inflation is expected to move around the lower bound of the target tolerance band throughout the projection horizon.

We also do not expect pressures from rising dinar-denominated **import prices** until the end of the projection horizon, in light of expected somewhat lower inflation in the international environment compared to the previous projection. Expected inflation is lower primarily in the euro area, our most important trade partner.

**Uncertainties surrounding the inflation projection** are associated primarily with movements in international commodity and financial markets, and administered price growth to an extent.

The prices of primary commodities in the **international commodity market** in the coming period could differ from the assumed, owing both to demand- and supply-side factors. In terms of demand-side factors, there are risks that the global economic slack could be sharper than estimated, which would diminish demand for primary commodities. Trade tensions between the leading world economies remain pronounced, as well as geopolitical tensions, which may undermine business confidence and reflect negatively on investment, productivity and economic growth. Trade tensions could also trigger a decline in demand for primary commodities, notably oil. Greater than expected slowdown of China's growth would reflect particularly on falling demand for primary commodities, given that the Chinese economy, boasting the highest investment spending in the world, is the main driver of demand for global primary commodities. Although China responded to the slowdown with monetary and fiscal stimuli, economic activity could still be lower than expected, particularly in the case of renewed escalation of trade tensions.

Supply-side factors are specific for each primary commodity. Although market participants, according to futures, expect somewhat lower **global oil prices** relative to the current level, shifts are possible in both directions given the unstable balance of global supply and demand. Namely, geopolitical tensions do not lose steam and there is uncertainty as to whether OPEC countries would cap the production more strongly and to what extent the members would adhere to the agreement. It is also uncertain as to how new standards of the International Maritime Organization, planned to take effect as of early 2020, would affect the oil processing and transport industry and what would be the impact on the global oil price, though no major market shifts are expected. On the

other hand, oil production in the US is dynamic and its growth, as well as a potentially higher rise in production of OPEC members, could additionally reduce the global oil price. Global oil prices will also reflect on the prices of **primary agricultural commodities**, notably cereals, not only through the costs of fuel in agricultural production and fertilisers prices, but also through the impact on biofuel production. However, in the past several years the prices of global primary commodity prices increased slightly, or even declined, although futures envisaged growth. Given the uncertainty as to the movement in global oil prices and primary agricultural commodities, the risks to the projection based on global primary commodity prices are assessed to be symmetric.

The risks to the projection are also associated with developments in the **international financial market**, notably the monetary policy stance of the ECB and Fed, and consequently conditions in the international financial market and the EUR/USD exchange rate. In October, the Fed again narrowed the federal funds rate range by 25 bp (to 1.50–1.75%), in order to maintain the economic growth in the US in conditions of the global growth slowdown. Although the Fed signalled that there should be no further cuts in the federal funds rate, unless the economic performance in the US deteriorates, futures suggest the rate would go further down.

In September, the ECB adopted a monetary stimulus package, signalling its readiness to resort to additional measures if needed, in order to bring inflation back to the target in the medium-term in a sustainable manner. Also, it is uncertain as to whether the countries would opt for fiscal stimuli, at least those that are in the position to do so. The uncertainty as to future conditions in the international financial market could trigger instability of global capital flows. Moreover, a further rise in protectionism in international trade could deepen the instability in the international financial market, and thus the uncertainty regarding capital flows.

The projection operates on the assumption of **administered price** growth of 3.4% this year, after the last year's relatively modest growth of 2.4%. For the coming period, we assumed a modest acceleration of these prices (to 3.7% in 2020 and 4% in 2021). However, since in the past few years these prices increased mostly slower than expected, we recognise the risks that they could rise less than expected, so the risks to the projection on this account are tilted to the downside.

**Overall, the risks to the inflation projection are judged to be symmetric until the end of the projection horizon.**

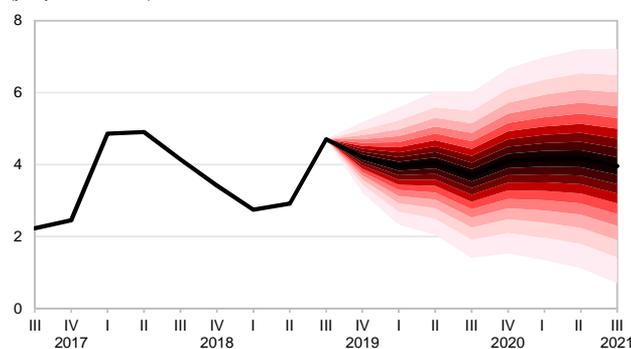
Monetary policy decisions in the coming period will continue to depend on the assessment of the impact of past monetary policy easing and other domestic and external factors on inflation in Serbia. Given that the key risks to the projection largely emanate from the international environment, the NBS will continue to carefully monitor and analyse trends in the international commodity and financial markets, and assess their impact on domestic economic developments. As so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium run, which will, along with the maintained financial stability, contribute to sustainable economic growth and preservation of macroeconomic stability.

### GDP projection

GDP growth accelerated in Q3 by 4.7% y-o-y and by 1.8% s-a q-o-q, led by the recovery of manufacturing after the completed overhauls in the oil and chemical industry and the activation of earlier investment, coupled with the high FDI inflow and further expansion in construction and service sectors. In Q4, GDP growth is also expected to remain relatively strong, driven by the same factors as in Q3, as well as by the last year’s low base in manufacturing (which was adversely affected by the sluggish external demand and the imposed taxes on products delivered to Kosovo and Metohija), so the annual GDP growth rate will amount to 3.6%, instead of the earlier expected 3.5%. At the annual level, positive contributions to growth will come from all service and production sectors, save for agriculture which is most likely to provide a neutral instead of the negative contribution which we anticipated in August assuming an average agricultural season. In our estimate, this will neutralise a somewhat lower contribution of industry than initially expected, since external demand slowed down further, while the taxes on products delivered to Kosovo and Metohija remained in force.

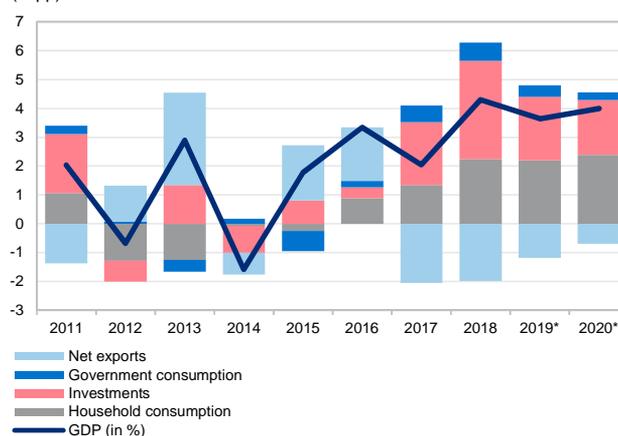
On the expenditure side, investment (estimated to reach 23% of GDP this year) remained the key factor of economic growth, thanks to the continued implementation of infrastructure projects, improvement of the business environment and favourable sources of private sector financing. Household consumption continued up, mostly owing to uninterrupted positive trends in the labour market, growth in consumer confidence and lower costs of credit. On the other hand, in view of the ongoing investment cycle at home and a further deceleration in external demand, the contribution of net exports is likely to be negative, but less so than in

Chart V.0.17 GDP growth projection  
(y-o-y rates, in %)



Source: NBS.

Chart V.0.18 Contributions to real GDP growth  
(in pp)



Sources: SORS and NBS.

\* NBS estimate.

2018, thanks to the stronger export capacities supported by the activation of earlier investment.

In 2020, GDP growth is expected to pick up to around 4% and maintain the same dynamics in the medium term as well. The greatest positive contributor to GDP growth should be household consumption (around 2.5 pp in 2020), given its dominant share in GDP composition. It is estimated that consumption will rise on sustainable grounds, i.e. causing no internal or external imbalance. The preservation of macroeconomic stability, favourable financial conditions, continued implementation of structural reforms, progress in the EU integration process and continued implementation of infrastructure projects should contribute to a further rise in fixed investment and their share in GDP (with contribution to GDP of close to 2 pp in 2020). The activation of investment, particularly in tradeable sectors, should ensure the preservation of a relatively strong pace of growth of goods and services exports, and the expected gradual recovery of external demand should work in the same direction. On the other hand, the continuation of investment cycle and increasing integration of domestic firms in global production chains will fuel the import of equipment and intermediate goods, while further growth in final consumption will spur the import of consumer goods. In such conditions, the contribution of net exports to GDP is most likely to remain negative in 2020 (-0.7 pp), transforming to neutral in the medium term.

On the production side, the strongest contribution to gradual acceleration of GDP growth in the medium run is likely to come from faster growth in manufacturing – resulting from the activation of new and expansion of the existing capacities on the supply side, and from gradual growth acceleration in our main foreign trade partners on the demand side. Acceleration is also expected in service sectors on account of continued positive trends in the labour market and elevated domestic demand. Construction is also likely to provide a strong impetus to GDP growth, in view of the ongoing and planned projects in the area of transport infrastructure, as well as favourable trends in the real estate market. The yields in agriculture production are assumed to hover around the multiannual average. In 2020, after another above-average agricultural season, this sector is likely to provide a mildly negative contribution to GDP growth. Speaking of projection for 2020, GDP growth should step up also on the back of a relatively high carry-over effect

(estimated at around 1.5 pp)<sup>35</sup>, given that economic activity in this year picked up in H2 and should move above the annual average in Q4.

Similarly to the previous projection, the risks to the GDP projection are assessed to be symmetric, whereas the risks arising from the international environment are tilted to the downside and those from the domestic environment to the upside.

The key risk emanating from the international environment concerns **the pace of growth in the euro area, and the relating pace of growth in the countries of Central and Southeast Europe**, with which the euro area, and increasingly Serbia as well, are fostering strong economic links. Although early in the year the euro area posted faster than expected growth, investor confidence was negatively affected by trade tensions stemming from protectionist measures of the leading world economies, as well as by the persisting geopolitical tensions, including the postponement of the final Brexit deal. Along with the subdued activity in the automobile industry, this unfavourably affected economic growth in the remainder of the year. While the majority of relevant international financial institutions expect a gradual acceleration of the euro area economy, the risks to this projection are tilted to the downside and their materialisation could slow down the Serbian exports and consequently dampen manufacturing output. On the other hand, the lifting of the 100% tax on products delivered to Kosovo and Metohija could positively impact the manufacturing output, primarily production of food.

As a small and open economy, Serbia is also under the influence of **capital flows and major currency pairs in the international financial market**. Slower economic growth and the presence of uncertainty in the international financial market due to trade and geopolitical tensions could reflect negatively on business confidence and investment decisions, which would likely lead to a lighter capital flow towards emerging countries, including Serbia. Still, the effects could be largely or fully offset by expansionary monetary policy measures of leading central banks, as there is possibility for further easing. Also, it should be stressed that owing to its preserved macroeconomic stability, narrowed internal and external imbalances, increased domestic savings and decreased need for external borrowing, Serbia has reduced its exposure to possible adverse developments in the international financial market.

<sup>35</sup> The effect of trends carried over from this year. For more details see the February 2018 Inflation Report – Text box 3, p. 40.

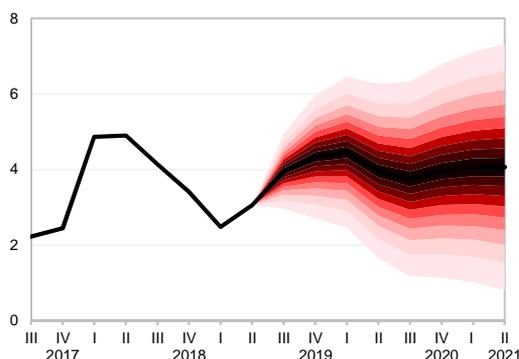
To a degree, risks to the GDP projection are also associated with **movements in the prices of primary commodities, notably oil, base metals and cereals**. As Serbia is a net importer of oil, the rise in oil price would translate into lower disposable income and higher operating expenses, while a price decrease would have the opposite effect. On the other hand, when it comes to prices of base metals (steel and copper in particular) and cereals, Serbia being a net exporter would benefit from any rise in the global prices of these commodities.

All things considered, risks to the projection on account of growth in the euro area and our other important foreign trade partners are judged to be skewed to the downside, while risks on account of developments in the international commodity and financial markets are assessed as symmetric.

Unlike risks emanating from the international environment, the effect of some domestic factors on GDP growth is judged to be tilted to the upside. This primarily pertains to the possibly **stronger growth in private investments** than initially assumed, as was the case both last and this year. Coupled with the continuation of structural reforms and plans to further and systematically improve the business climate, this should also contribute to faster growth in total factor productivity. At the same time, better than planned execution of capital government expenditure in 2018 and 2019 indicates that government investments in the coming period could increase faster than expected. Since investments are mostly challenged to tradeable sectors, their increased activation should help accelerate export growth, observed on the expenditure side, and manufacturing growth, on the production side. Moreover, construction may also see more favourable

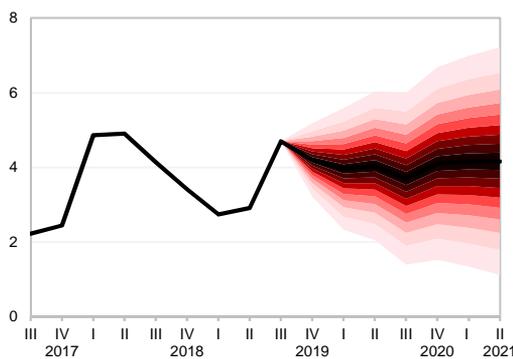
Chart V.0.19 **Current vs. previous GDP growth projection**

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



Source: NBS.

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



developments than expected, mostly on account of the prolonged and strong investment in infrastructure and positive trends in real estate.

Another risk to the GDP projection pertains to developments in **agricultural production**, which we assumed to be average in 2020, as in the coming years. Since this projection may deviate either way, mostly due to agrometeorological conditions, risks on this account are judged to be symmetric.

## Comparison and outcome of inflation projections

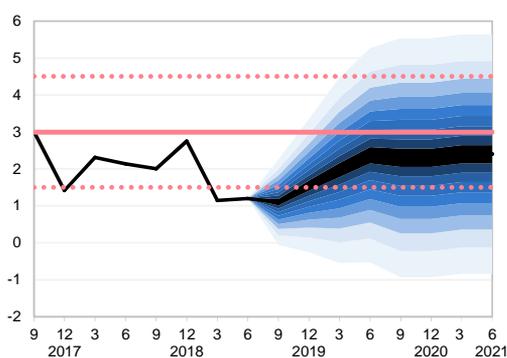
Compared to the projection in the August *Inflation Report*, the new medium-term projection is lower until mid-2020, and then somewhat higher until the end of the projection horizon. The main reason for lower projected inflation until mid-2020 is sharper than expected fall in vegetable prices in Q3, which drove down the projected y-o-y inflation rates until the middle of next year, only to increase them thereafter on account of the base effect.

Continuing appreciation pressures are pushing the inflation projection down and, on that account, the projected hike in the prices of non-food products is somewhat lower than in the August projection, despite the slightly faster narrowing of the output gap. Additionally, the lower hike in the prices of non-food products and services will be facilitated by lower inflation in the international environment, effected through lower imported inflation.

On the other hand, projected food inflation is somewhat higher on account of higher global prices of pork which have been on the rise since March 2019 due to the rising demand in East Asia. Another factor leading to higher

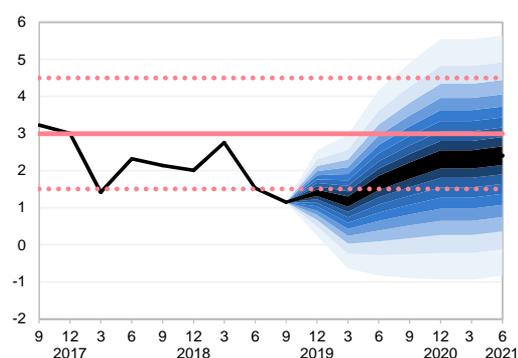
Chart V.0.20 Current vs. previous inflation projection

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



Source: NBS.

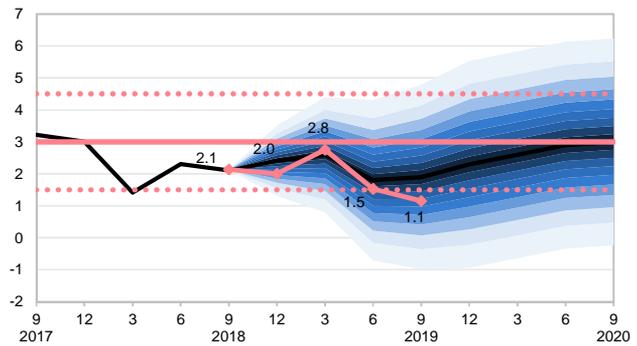
**November projection**  
(y-o-y rates, in %)



projected food inflation is the output gap which is narrowing in the new projection faster than in the previous one.

**As for the outcome of the November 2018 projection, we can see that until mid-2019 inflation was aligned with the central values projected a year ago. Only in Q3 2019 did inflation trend below the central projection.** The key reasons for inflation undershooting our central projection from a year ago were **lower global prices of oil and administered prices**. Global oil prices were around 20% lower than the ones we assumed in our November 2018 projection, based on futures, therefore domestic prices of petroleum products were also lower, including their contribution to inflation. Also, administered prices gave a lower contribution, as they too posted more modest growth in Q3 2019 (2.1% y-o-y) than what was assumed in the November 2018 projection (3.3% y-o-y).

Chart V.0.21 **Achievement of November 2018 inflation projection** (y-o-y rates, in %)



Source: NBS.

Table A  
Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Q1 2019	Q2 2019	Q3 2019
<b>EXTERNAL LIQUIDITY INDICATORS (in %)</b>																	
FX reserves/imports of goods and services (in months)	6.1	9.0	7.5	5.4	9.7	8.4	8.8	7.7	7.6	6.6	6.7	6.2	5.4	5.3	5.3	5.4	5.8
FX reserves/short-term debt	177.0	265.1	250.6	162.6	220.6	191.2	299.9	237.3	268.6	294.0	256.4	234.0	200.1	254.7	240.8	252.3	
FX reserves /GDP	22.1	34.8	30.5	22.9	32.6	31.7	34.0	32.4	30.7	27.9	29.1	27.8	25.4	26.3	26.4	27.7	29.7
Debt repayment/GDP	4.7	9.7	9.6	10.1	12.1	11.3	11.7	12.3	12.6	13.3	11.1	12.3	10.9	11.3	8.8	8.3	
Debt repayment/exports of goods and services	19.8	36.2	37.5	37.5	48.8	37.5	37.3	36.0	33.0	32.7	25.2	25.9	22.2	22.8	16.7	15.9	
<b>EXTERNAL SOLVENCY INDICATORS (in %)</b>																	
External debt/GDP	56.2	55.2	55.1	58.8	68.6	74.5	68.1	76.1	70.4	72.4	73.5	72.1	65.3	62.6	62.7	63.4	
Short-term debt/GDP	12.5	13.1	12.2	14.1	14.8	16.6	11.3	13.7	11.4	9.5	11.3	11.9	12.7	10.3	11.0	11.0	
External debt/exports of goods and services	234.9	205.7	214.3	218.9	276.9	247.1	216.5	223.6	184.0	177.7	166.8	152.4	132.4	126.3	124.8	124.6	
<b>FINANCIAL RISK EXPOSURE INDICATORS (in %)</b>																	
FX reserves/M1	290.3	356.1	306.7	300.4	393.4	416.6	429.6	402.1	330.4	278.1	250.2	207.3	176.2	168.0	183.3	185.2	188.8
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	199.9	196.6	193.7	196.6	185.0	171.4	176.6	198.1	207.6
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	67.1	73.0	74.7	78.0	65.1	75.3	78.0	84.5	87.1	91.8	96.2	100.7	106.3	108.8	116.0	114.5	111.3
<b>MEMORANDUM: (in EUR million)</b>																	
GDP <sup>1)</sup>	22,276	25,906	31,551	35,701	32,486	31,546	35,432	33,679	36,427	35,467	35,716	36,723	39,183	42,855	10,197	11,284	11,928 <sup>9)</sup>
External debt	12,520	14,291	17,382	20,982	22,272	23,509	24,123	25,645	25,644	25,679	26,234	26,494	25,573	26,829	27,142	27,817	
External debt servicing	1,054	2,513	3,039	3,594	3,922	3,564	4,154	4,130	4,595	4,728	3,960	4,508	4,285	4,849	896	940	
Central bank foreign exchange reserves	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	9,907	10,378	10,205	9,962	11,262	11,440	12,146	13,295
Short-term debt <sup>2)</sup>	951	968	1,044	1,832	1,852	1,758	612	455	196	99	303	672	893	1,480	1,277	1,525	
Current account balance	-1,778	-2,356	-5,474	-7,126	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-1,234	-1,075	-2,051	-2,223	-893	-744	-639
<b>CREDIT RATING (change of rating and outlook)</b>																	
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2017	2018	2019	
	July/May	Feb	July	March/Dec	Dec	Nov	March	Aug	July	Jan	Dec	Jan/March/June/Dec	March	Dec	Dec	Sept	
S&P	BB- /stable	BB- /positive	BB- /stable	BB- /negative	BB- /stable		BB /stable	BB- /negative				BB- /positive		BB /stable	BB /positive		
Fitch	BB- /stable			BB- /negative		BB- /stable		BB- /negative		B+ /stable	B+ /positive	BB- /stable		BB /stable		BB+ /stable	
Moody's									B1 /stable			B1 /positive	Ba3 /stable		Ba3 /positive		

## Methodological notes:

Foreign exchange reserves/imports of goods and services (in months) - ratio of end-of-period foreign exchange reserves to average monthly imports of goods and services during period under review.  
 Foreign exchange reserves/short-term debt (in %) - ratio of foreign exchange reserves to stock of short-term debt at remaining maturity at end-of-period.  
 Foreign exchange reserves/GDP (in %) - ratio of end-of-period foreign exchange reserves to GDP.  
 Debt repayment/GDP (in %) - ratio of debt repayment (excl. early repayment of a part of debt to London Club creditors) to GDP during period under review.  
 Debt repayment/exports (in %) - ratio of debt repayment (excl. early repayment of a part of debt to London Club creditors) to exports of goods and services during period under review.  
 External debt/GDP (in %) - ratio of end-of-period outstanding debt to GDP.  
 Short-term debt/GDP - ratio of end-of-period short-term debt at remaining maturity to GDP.  
 External debt/exports (in %) - ratio of end-of-period outstanding debt to annual value of exports of goods and services.  
 Foreign exchange reserves/M1 (in %) - ratio of foreign exchange reserves to money supply at end-of-period.  
 (Exports + imports)/GDP (in %) - ratio of value of exports and imports of goods and services to GDP during period under review.

<sup>1)</sup> According to ESA 2010.

<sup>2)</sup> At original maturity.

<sup>3)</sup> NBS estimate.

## Notes:

- The Statistical Office revised GDP data for the period 2005-2017, which led to a change in the share of macroeconomic indicators in GDP.
- Data are subject to corrections in line with the official data sources.
- Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM5.
- As of 1 January 2010 the Serbian Statistical Office applies the general trade system of registration of exports and imports which is a broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using the special trade system. Trade with Montenegro is registered within relevant transactions as of 2003.
- In September 2010, the methodology of external debt statistics was changed - public sector external debt now includes liabilities under SDR allocation (EUR 475.1 mn) used in December 2009. Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 974.8 million, of which EUR 422.6 million relating to domestic banks and EUR 552.2 million to domestic enterprises).
- Foreign debt repayment does not include: short-term debt repayment and advance debt repayment.

**Table B**  
**Key macroeconomic indicators**

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Q1 2019	Q2 2019	Q3 2019
Real GDP growth (in %) <sup>1)</sup>	5.5	4.9	6.4	5.7	-2.7	0.7	2.0	-0.7	2.9	-1.6	1.8	3.3	2.0	4.4	2.7	2.9	4.7 <sup>9)</sup>
Consumer prices (in %, relative to the same month a year earlier) <sup>2)</sup>	17.7	6.6	11.0	8.6	6.6	10.3	7.0	12.2	2.2	1.7	1.5	1.6	3.0	2.0	2.8	1.5	1.1
NBS foreign exchange reserves (in EUR million)	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	9,907	10,378	10,205	9,962	11,262	11,440	12,146	13,295
Exports (in EUR million) <sup>3)</sup>	5,329	6,948	8,110	9,583	8,043	9,515	11,145	11,469	13,937	14,451	15,728	17,385	19,312	21,238	5,363	5,912	6,137
- growth rate in % compared to a year earlier	19.1	30.4	-	18.2	-16.1	18.3	17.1	2.9	21.5	3.7	8.8	10.5	11.1	10.0	10.6	10.8	11.4
Imports (in EUR million) <sup>3)</sup>	9,612	11,970	15,468	18,267	13,099	14,244	16,487	16,992	17,782	18,096	18,643	19,597	22,343	25,392	6,464	7,012	7,140
- growth rate in % compared to a year earlier	0.7	24.5	-	18.1	-28.3	8.7	15.7	3.1	4.7	1.8	3.0	5.1	14.0	13.6	12.2	12.3	10.5
Current account balance <sup>3)</sup> (in EUR million)	-1,778	-2,356	-5,474	-7,125	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-1,234	-1,075	-2,051	-2,223	-893	-744	-639
as % of GDP	-8.0	-9.1	-17.3	-20.0	-6.3	-6.5	-10.3	-10.9	-5.8	-5.6	-3.5	-2.9	-5.2	-5.2	-8.8	-6.6	-5.4
Unemployment according to the Survey (in %) <sup>6)</sup>	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	19.2 <sup>7)</sup>	17.7	15.3	13.5	12.7	12.1	10.3	
Wages (average for the period, in EUR) <sup>7)</sup>	210.4	257.8	347.1	402.0	337.8	331.8	372.5	366.1	388.5	379.8	367.9	374.5	383.9	419.7	454.5	462.4	463.4
RS budget deficit / surplus (in % of GDP) <sup>4)</sup>				-1.6	-3.0	-3.2	-3.8	-5.6	-4.9	-5.9	-2.7	-0.2	0.7	0.6	1.3	0.4	2.0
Consolidated fiscal result (in % of GDP) <sup>4)</sup>	1.1	-1.4	-1.8	-2.5	-4.2	-4.3	-4.5	-6.4	-5.1	-6.2	-3.5	-1.2	1.1	0.6	1.0	0.5	1.2
RS public debt, (central government, in % of GDP) <sup>8)</sup>	47.6	33.9	27.9	26.8	30.9	39.5	42.8	52.9	56.0	66.2	70.0	67.8	57.9	53.7	51.0	51.4	52.0
RSD/USD exchange rate (period average)	66.87	67.03	58.39	55.76	67.47	77.91	73.34	88.12	85.17	88.54	108.85	111.29	107.50	100.28	104.06	104.95	105.82
RSD/USD exchange rate (end of period)	72.22	59.98	53.73	62.90	66.73	79.28	80.87	86.18	83.13	99.46	111.25	117.14	99.12	103.39	105.00	103.77	107.43
RSD/EUR exchange rate (period average)	82.99	84.11	79.96	81.44	93.95	103.04	101.95	113.13	113.14	117.31	120.73	123.12	121.34	118.27	118.23	117.97	117.72
RSD/EUR exchange rate (end of period)	85.50	79.00	79.24	88.60	95.89	105.50	104.64	113.72	114.64	120.96	121.63	123.47	118.47	118.19	117.97	117.91	117.53
MEMORANDUM:																	
GDP (in EUR million) <sup>5)</sup>	22,276	25,906	31,551	35,701	32,486	31,546	35,432	33,679	36,427	35,467	35,716	36,723	39,183	42,855	10,197	11,284	11,928 <sup>9)</sup>

<sup>1)</sup> At constant prices of previous year.

<sup>2)</sup> Retail prices until 2006.

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

<sup>4)</sup> Includes below-the-line items (payment of called guarantees, bank recapitalisations and debt takeover) in line with IMF methodology, as of 2008 on RS budget level and as of 2005 on consolidated level.

<sup>5)</sup> According to ESA 2010.

<sup>6)</sup> New methodology of Labour Force Survey since 2014.

<sup>7)</sup> Until 2017, wages are shown according to the old methodology. Since 2017, wages are published according to the new methodology and data are based on Tax Administration evidence. For conversion of wages from RSD to EUR, we used the average of the period RSD/EUR exchange rate. Q3 2019 wages are the average of July-August data.

<sup>8)</sup> Data on the share of public debt in GDP were downloaded from the website of the Public Debt Administration.

<sup>9)</sup> NBS estimate.

Notes:

1. The Statistical Office revised GDP data for the period 2005-2017, which led to a change in the share of macroeconomic indicators in
2. Data are subject to corrections in line with official data sources.
3. Source for the data on unemployment: Labour Force Survey, Statistical Office.
4. Source for public debt: MoF.

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## Executive Board meetings and changes in the key policy rate

### 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	3.00	0

### 2019

Date	Key policy rate (p.a, in %)	Change (in basis points)
10 January	3.00	0
7 February	3.00	0
7 March	3.00	0
9 April	3.00	0
9 May	3.00	0
6 June	3.00	0
11 July	2.75	-25
8 August	2.50	-25
12 September	2.50	0
10 October	2.50	0
7 November	2.25	-25
12 December		

## Press releases from NBS Executive Board meetings

### Press release from Executive Board meeting held on 12 September 2019

At its meeting today, the NBS Executive Board voted to keep the key policy rate at 2.5%.

In making the decision, the Executive Board was guided primarily by the August medium-term inflation projection and the expected movement in other macroeconomic indicators from the domestic and international environment in the coming period, and the need to fully analyse the effects of past monetary policy easing. According to the August medium-term inflation projection as well, inflation will be kept firmly under control, as in the previous years. The Executive Board reminds that, consistent with expectations, y-o-y inflation slowed down as of May, reflecting the reduced contribution of fruit and vegetable prices in the new agricultural season. That inflationary pressures are low is also indicated by core inflation, which remains low and stable, and by one- and two-year ahead inflation expectations of the financial and corporate sectors standing in the lower part of the target band. All this supports the rationale behind the decisions to cut the policy rate at the two previous Executive Board meetings, in July and August.

Caution in the monetary policy pursuit is still warranted, mostly due to the developments in the international environment. The NBS judges that uncertainty in the international financial and commodity markets is primarily associated with the impact of trade tensions and the potential effects of the politics of leading world economies on global movements. The ECB announced additional monetary stimulus, while the Fed lowered its policy rate in July, in accordance with expectations, which facilitates the preservation of favourable global financial conditions. Yet it remains to be seen if these measures by the Fed imply the beginning of a new cycle of monetary policy easing, i.e. whether the federal funds rate will continue to be trimmed going forward or perhaps this is merely a “one-off adjustment”. Movements in the price of oil and primary agricultural commodities in the global market are also uncertain given the intricate influence of numerous factors on the demand and supply side, which is why caution in the monetary policy conduct is still mandated.

The Executive Board reminds that earlier this month Moody’s upgraded the outlook on Serbia’s credit rating from stable to positive, which is yet another proof of the strengthening of the domestic economy and favourable macroeconomic prospects. The resilience of our economy to potential negative effects from the international environment has increased as a result of reduced internal and external imbalances and a favourable macroeconomic outlook. Positive fiscal trends with a surplus in public finances, recorded in the past two years, continued in the first seven months of 2019, and the current account deficit has been fully covered by the net FDI inflow. Y-o-y, industrial production went up by 3.7% in July. This growth was led by manufacturing, which increased by 6.0% y-o-y and by 8.2% m-o-m seasonally-adjusted. The y-o-y growth in manufacturing was widely dispersed and was recorded in 18 out of 24 branches. The Executive Board expects that the 3.5% economic growth this year will be led by domestic demand, i.e. investment and consumption, and that FDIs, which boost Serbia’s production and export capacities, will remain one of the factors of external sustainability in the medium run.

The next rate-setting meeting is scheduled for 10 October.

### Press release from Executive Board meeting held on 10 October 2019

At its meeting today, the NBS Executive Board voted to keep the key policy rate at 2.5%.

In making the decision, the Executive Board was guided primarily by the outlook for inflation and other macroeconomic indicators in the domestic and international environment and the past monetary policy easing. The Executive Board stresses that inflation will be kept under control in the coming period, as was the case so far. Inflation slowed down to 1.3% y-o-y in August, on the back of a further reduction in the contribution of fruit and vegetable prices in the new agricultural season. That inflationary pressures are subdued is also indicated by core inflation, which remains low and stable, and by the one- and two-year ahead inflation expectations of the financial and corporate sectors standing in the lower part of the target band.

Caution in the monetary policy pursuit is still warranted, mostly due to the developments in the international environment. The NBS judges that international financial and commodity markets are largely affected by uncertain trade policies of leading world economies and global economic slack. Support to global economy is coming from the monetary policies of leading central banks – the ECB started implementing new monetary stimuli in September, while the Fed lowered the funds rate once again in September, in line with expectations, which should give an additional positive contribution to global financial conditions. However, it remains uncertain to what extent the monetary policies

of leading central banks will differ from market expectations, which could affect capital flows towards emerging economies. Movements in international oil and primary agricultural commodity prices are also uncertain given the intricate influence of numerous factors on the demand and supply side, which is why caution in the monetary policy conduct is still mandated.

The resilience of the Serbian economy to potential negative effects from the international environment has strengthened as a result of reduced internal and external imbalances, favourable macroeconomic outlook, as well as an increasing level of FX reserves. Positive fiscal trends with a surplus in public finances, recorded in the past two years, have continued into 2019, and the current account deficit has been fully covered by the net FDI inflow. Economic indicators point to a pick-up in oil and chemical industry in the wake of the completed overhauls, which together with stronger activity in construction and services will provide impetus to GDP growth in Q3. These movements are in line with our projection of 3.5% GDP growth this year, led by domestic demand, i.e. investment and consumption.

The Executive Board underlines the fact that after Moody's upgraded Serbia's outlook from stable to positive, Fitch Ratings increased Serbia's Long-Term Foreign and Local-Currency Issuer Default Ratings from BB to BB+. Thus, thanks to the maintained stability and transformation of its economy, Serbia is, for the first time, only one step away from investment grade, characteristic of economies offering high security of investment. This does not only confirm the economic progress and the results achieved, but also contributes to further improvement in financing conditions and growth of investment in Serbia.

The next rate-setting meeting is scheduled for 7 November.

#### **Press release from Executive Board meeting held on 7 November 2019**

At its meeting today, the NBS Executive Board cut the key policy rate to 2.25%, its new lowest level in the inflation targeting regime, whereby the NBS lends further support to credit and economic growth.

In making the decision, the NBS was guided primarily by the further weakening of inflationary pressures. Similarly to other countries in the region, as the contribution of food prices declined, primarily of vegetables in the new agricultural season, and in light of lower global oil prices, y-o-y inflation in Serbia decelerated in the past several months, reaching 1.1% in September. Subdued inflationary pressures are also indicated by core inflation, which remains low and stable, as well as inflation expectations of financial and corporate sectors being in the lower half of the target band for both one and two years ahead. According to the November central projection, y-o-y inflation will move around the lower bound of the target tolerance band until the end of this year and in the first half of 2020. It is expected to gradually converge to the target midpoint in the medium term, reflecting elevated aggregate demand.

The Executive Board underlines that the resilience of our economy to potential negative effects from the international environment has increased owing to reduced internal and external imbalances, favourable macroeconomic prospects and the record high level of FX reserves. As in the previous two years, public finances are in a surplus, and the current account deficit is fully covered by the net FDI inflow for the fifth year in a row. The latest economic indicators point to a higher than projected GDP growth in Q3, led by the recovery of manufacturing after the completed overhauls in the oil and chemical industry and activation of prior investments, as well as by the pick-up in construction and services. In the year to date, domestic factors managed to compensate for the weaker external demand. Investment continues to grow on the back of further implementation of infrastructure projects, improved business environment and favourable financing conditions. Household consumption also continues to rise on sustainable grounds, owing primarily to the prolonged positive labour market trends and lower cost of borrowing.

In addition to favourable domestic macroeconomic conditions of monetary policy conduct, the Executive Board's decision to trim the key policy rate further was also influenced by developments in the international environment, notably the slowdown in global trade and growth, and by the monetary policy accommodation by leading central banks. In September the ECB adopted a new monetary stimulus package (the largest in three years) and announced its readiness to go to even greater lengths until a sustainable convergence of inflation to the target is achieved. As expected, in October the Fed trimmed its federal funds rate again. This will help preserve favourable global financial conditions, which should reflect positively on capital flows to emerging countries. In addition, inflationary pressures in the international environment remain low, notably in the euro area, Serbia's key foreign trade partner.

At today's meeting, the Executive Board adopted the November Inflation Report, which will be presented to the public on 14 November. On that occasion, we will give a detailed account of monetary policy decisions and underlying macroeconomic trends.

The next rate-setting meeting is scheduled for 12 December.

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