ANNUAL MONETARY POLICY REPORT

2010

National Bank of Serbia

ANNUAL MONETARY POLICY REPORT

2010

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

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

www.nbs.rs
Number of copies: 55
ISSN 2217-6535

Introductory note

The National Bank of Serbia is required to submit to the Parliament its annual and semi-annual monetary policy reports, explaining all the factors that affected the implementation of monetary policy in the period under review. The annual report must be submitted by 30 June and the semi-annual by 30 September[1].

Pursuant to the By-Law of the National Bank of Serbia[2], the above reports must present and analyse the monetary policy strategy, macroeconomic developments (international environment, balance of payments, the country's international investment position, external debt, movements in monetary aggregates, prices, wages and employment, and other macroeconomic movements), monetary policy defined and monetary policy implemented (defined vs. achieved monetary policy objectives, monetary policy instruments and measures applied, and other monetary policy-related issues), as well as outline the monetary policy planned.

The Annual Monetary Policy Report for 2010 was adopted by the NBS Executive Board at its meeting of 23 June 2011.

Monetary policy reports are available on the National Bank of Serbia's website (http://www.nbs.rs).

Executive Board of the National Bank of Serbia:

Dejan Šoškić, *Governor*

Ana Gligorijević, *Vice-Governor*

Bojan Marković, *Vice-Governor*

Mira Erić-Jović, *Vice-Governor*

[1] Law on the National Bank of Serbia , RS Official Gazette, Nos 72/2003, 55/2004, 85/2005 – other law and 44/2010 (Article 71, paragraphs 2 and 3).
[2] RS Official Gazette, No 71/2010 (Article 38).

ABBREVIATIONS

bln – billion
bp – basis point
CPI – Consumer Price Index
ECB – European Central Bank
EMBI – Emerging Markets Bond Index
FED – Federal Reserve System
FISIM – Financial Intermediation Services Indirectly Measured
GDP – Gross Domestic Product
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
mln – million
NAVA – non-agricultural value added
pp – percentage point

Other generally accepted abbreviations are not cited.

Contents

I. Monetary policy framework

The National Bank of Serbia (NBS) has been implementing fully fledged inflation targeting since early 2009, though elements of the strategy were gradually introduced into practice since 2006. In December 2008, the Monetary Policy Committee[3] of the National Bank of Serbia adopted the *Memorandum on Inflation Targeting as a Monetary Strategy* defining formal implementation of the inflation targeting regime from 1 January 2009. The Memorandum was drafted along the lines of the *Agreement on Inflation Targeting between the National Bank of Serbia* and the Government of the Republic of Serbia, adopted at the Government session of 19 December 2008. In the best collective judgement of the NBS and the Government of the Republic of Serbia, this was the most adequate monetary policy regime under the prevailing circumstances.

The inflation targeting regime has so far been adopted by a number of central banks worldwide[4] as a pragmatic response to the failure of other monetary policy regimes. The choice of the regime was strengthened by the awareness that permanently high rates of inflation adversely affect economic growth and employment and that the monetary policy focus should therefore be shifted from short-term demand management to medium-term price stability which lies at the core of inflation targeting. The inflation targeting regime is a framework rather than a set of rigid monetary policy rules: it is based on a numerical target for inflation in the medium term and a discretionary right to respond to economic shocks in the short term.

The inflation target of the NBS is defined in terms of the headline inflation rate (with a tolerance band) measured as an annual percentage change in the Consumer Price Index (CPI). Inflation targets are set in cooperation with the Government based on the analysis of current and expected macroeconomic developments and numerical guidelines for the increase in prices of goods and services under direct or indirect government regulation. In late 2009, the Monetary Policy Committee of the National Bank of Serbia adopted inflation targets for the period until end-2012[5] consistent with the need to achieve medium-term price stability. Inflation targets are set as point targets (with a tolerance band) for each month of the year, while end of year targets are set as follows:

- December 2009: 8 ± 2%,
- December 2010: 6 ± 2%,
- December 2011: 4.5 ± 1.5%,
- December 2012: 4 ± 1.5%.

Inflation targets reflect the intention to achieve price stability through gradual disinflation, without causing any disruptions to the macroeconomic processes. In line with the process of gradual disinflation, inflation targets remain above the quantitative definition of price stability and the level of inflation targets in advanced countries (2.0% or 2.5%), echoing that the process of price deregulation has not been completed in Serbia nor the process of economic and price convergence to the EU.

[3] In line with the Law on Amendments and Supplements to the Law on the National Bank of Serbia (RS Official Gazette, No 44/2010), the Executive Board assumed all powers of the Monetary Policy Committee.

[4] Currently, there are 27 fully fledged inflation targeters, advanced and emerging countries alike, while several central banks are operating implicit inflation targeting regimes, i.e. regimes preceding a formal switch to full fledged inflation targeting.

[5] *Memorandum of the National Bank of Serbia on Setting Inflation Targets for the Period 2010–2012*, adopted by the Monetary Policy Committee at its meeting of 14 December 2009.

It should be borne in mind that the inflation target is a medium-term objective, i.e. that the actual inflation outturn may diverge from the target in the short run due to exogenous shocks. As so far, monetary policy will not react to the primary effects of those shocks, but only to their second-round effects.

The NBS strives to achieve the targeted rate of inflation through changes in its key policy rate, which is the interest rate charged on two-week repo operations. This interest rate represents the key monetary policy instrument and the decisions on its level are based on the analysis of economic circumstances, assessment of future developments and the medium-term inflation projection. Other monetary policy instruments play a supporting role – by contributing to the smooth transmission of the impact of the key policy rate on market rates as well as to the development of the financial market, without jeopardising stability of the financial system.

The NBS runs a managed floating exchange rate regime which implies the right to intervene in case of excessive daily fluctuations in the foreign exchange market, threats to financial and price stability, and risks to the adequate level of foreign exchange reserves.

To improve transparency of its monetary policy and the effectiveness of communication with the public, the Executive Board of the NBS takes monetary policy decisions, in line with the agreed schedule of meetings, and regularly informs the public about the implementation of inflation targets and measures taken to achieve them in the future.

II. Monetary policy and achievement of targeted inflation

1. Monetary policy in 2010

A sharp drop in aggregate demand and inflation expectations led to further monetary easing in the first half of the year. Domestic demand was held back by the freeze on pensions and public sector wages and by rather low real growth in private sector wages. The pass-through from the exchange rate to core inflation was weaker than expected and food prices continued down.

The key policy rate was cut in three steps to 8% (in March, April and May by 50 basis points each). Monetary easing was also aided by the new decision on required reserves of banks, which entered into force on 18 March and became applicable on 18 April. The decision provided for gradual harmonisation with the new reserve requirement ratios and encouraged bank activity both on the side of assets (bank lending) and liabilities (deposit accumulation and foreign borrowing). The degree of monetary policy expansiveness was amplified by the weakening of the dinar and widening of the depreciation gap of the real exchange rate.

Y-o-y inflation continued down in the first half of 2010, settling in June below the lower bound of the target tolerance band for the sixth consecutive month. In accordance with the *Agreement on Inflation Targeting*, the NBS wrote an open letter to the Government to explain the reasons for the divergence, propose economic policy action and the time needed to bring inflation back within the target band. The letter cited unexpectedly low aggregate demand and the fall in food prices as the key reasons behind the inflation target undershooting. No additional monetary measures were proposed as those taken by that time were judged to be sufficient for steering inflation back within the target band already in the second half of the year.

The escalation of the sovereign debt crisis in some of the neighbouring eurozone members triggered a rise in risk premiums of South East European countries, Serbia included. The rising risk premium and the weakening of the dinar in May and June fed through into higher import prices and inflation expectations. This notwithstanding, around mid-year it seemed that inflation would be moving within the target band. However, a bad agricultural season and a sharp rise in global food prices caused significant food price increases in Serbia, which provided the main boost to inflation in the second half of the year. In a bid to quell inflationary pressures, the Executive Board shifted its monetary policy stance and started raising the key policy rate. From August until the end of the year, the key policy rate was raised five times to reach 11.5%. However, due to the strength and character of the shock, inflation shot past the upper bound of the target tolerance band already in October. It continued rising in the two months that followed, mainly in response to food price hikes, settling at year-end at 10.3% compared to the 6±2% target.

To contain inflationary pressures, the NBS tightened further its monetary policy stance in 2011. Full effects of its measures are yet to be felt. The NBS will continue to use all available monetary policy instruments to stabilise inflation around the target in the medium run.

2. Monetary policy instruments

The main instrument of the NBS is the key policy rate, i.e. interest rate applied in two-week repo operations. Other instruments of monetary regulation are also used, notably reserve requirements and operations in the FX market.

Open market operations

Two-week repo operations at the NBS's key policy rate are the main instrument for implementing open market operations. The role of the key policy rate is supported by the corridor of interest rates on deposit and lending facilities and by other open market operations.

The key policy rate equalled 9.5% p.a. at end-2009 and was changed during 2010 in the following dynamics:

• it was lowered from March to May by 1.5 pp in total – at end-March down to 9.0%, in early April to 8.5% and mid-May to 8.0%;

• it was raised from August to December by 3.5 pp in total – in early August to 8.5%, in early September to 9.0%, mid-October to 9.5%, mid-November to 10.5% and early December to 11.5%, where it stayed until the end of the year.

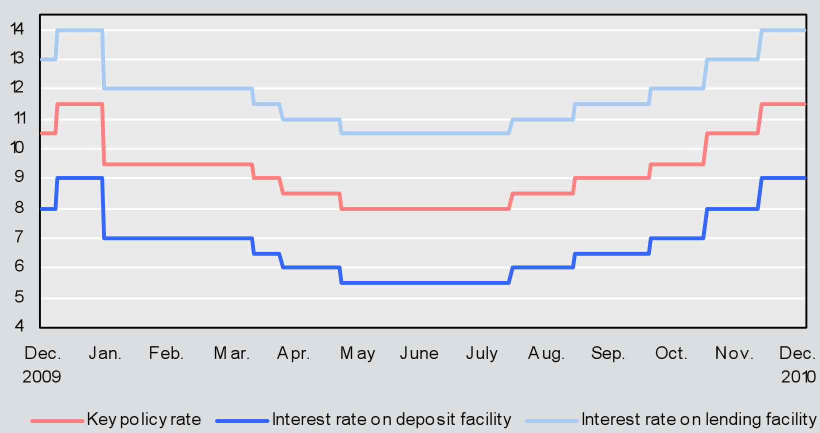
In 2010, the NBS implemented open market operations by trading in own securities. To mop up excess liquidity in the banking system, the NBS issued one series of treasury bills for the purposes of repo sale in the nominal amount of RSD 500 bln. The issue of one series of high nominal value is in line with the practice in previous years, which facilitates liquidity management for banks and enables more adequate management of securities of the same series.

During the year, 52 repo sale auctions were held. Two-week repo auctions were organised once a week at the fixed rate. The volume of sale totalled RSD 2,499.5 bln, and was lower than in 2009 (RSD 3,121.9 bln) and 2008 (RSD 5,239.1 bln).

After increasing in H2 2009, the sale of NBS securities headed down in H1 2010 and the stock of these securities in banks' portfolio fell from RSD 148 bln to RSD 136 bln. Relative to end-2009, the stock of NBS securities in banks' portfolio fell by RSD 46 bln to RSD 105.7 bln at end-June. The most important contributory factors were depreciation pressures and the National Bank's sale of foreign exchange in the interbank FX market, which resulted in the withdrawal of dinar liquidity.

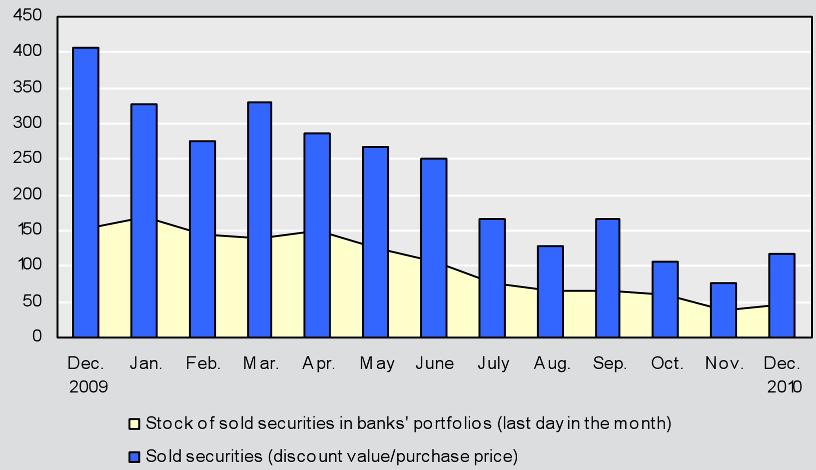
The sale of NBS securities plummeted further in H2. The lowest monthly volume was registered in November (RSD 77.7 bln), while the lowest stock of sold securities was recorded in early December (RSD 36.6 bln). The sale picked up mildly in the course of December, and the stock of sold securities came at RSD 46.9 bln at the end of the year, which is much below end-2009 when the stock of NBS securities in banks' portfolio measured RSD 151.7 bln. In 2010, banks financed the purchase of foreign exchange from the NBS mostly at the expense of their repo stock (RSD 104.8 bln), using funds freed up under lowered dinar reserve requirements.

Chart II.2.1. Key policy rate and interest rate corridor
(daily data, p.a, %)



Source: NBS.

Chart II.2.2. Repo sales and stock of sold securities
(RSD bln)



*Deflated by inflation, excluding the effect of exchange rate changes.

Source: NBS.

To sterilise liquidity freed up under lowered dinar reserve requirements, the NBS organised in April one auction of outright sale of RS bonds (in the nominal amount of RSD 10.7 bln), issued in 2004 for the settlement of liabilities to the NBS.

Deposit and lending facilities

In the course of 2010, banks made overnight deposits with the NBS in accordance with the *Decision on Terms and Conditions of Depositing Excess Liquidity with the National Bank of Serbia*. There were no amendments to the Decision during the year.

The average stock of bank deposits with the NBS equalled RSD 1.78 bln, with the lowest average monthly stock recorded in February (RSD 0.53 bln) and the highest in December (RSD 5.73 bln).

In 2010, the NBS continued implementing the decision which prescribes the terms and conditions of approving daily liquidity loans to banks against the collateral of securities. The decision was amended in June to the effect that the remaining maturity of dinar and foreign currency securities of the Republic of Serbia, at the moment of their placing as collateral with the NBS, was extended from one to two years.

The disbursement of daily liquidity loans increased in 2010 in the form of intra-day and overnight facilities. Intraday loans were used by 12 banks throughout the whole year, while only eight banks used overnight loans, all of which were disbursed in the course of June. Overall, the disbursement of intraday loans amounted to RSD 470 bln, while that of overnight loans was much lower – RSD 36.6 bln.

Reserve requirements (dinar and foreign currency)

In accordance with the *Monetary Policy Programme of the National Bank of Serbia for 2010*, the NBS continued using reserve requirements as a supporting monetary policy instrument.

In March 2010, the new *Decision on Banks' Required Reserves with the National Bank of Serbia* was adopted in order to restore the effectiveness of this monetary policy instrument. Namely, this instrument was often used for the purposes of easing the negative effects of the global economic crisis, and was characterised by overly differentiated rates, a large number of exemptions (on both the assets and liabilities side) and a non-unified structure of allocations involving complex calculations.

The new Decision:

– changed the reserve base so that the dinar base comprised only non-indexed liabilities, and the foreign currency base was extended to include foreign currency-indexed dinar liabilities;

– adjusted the number of exemptions from foreign currency reserve requirements –permanent exemption of liabilities under funds received from international financial institutions and/or foreign governments through intermediation of the government as the main debtor or received directly; permanent exemption of subordinated liabilities eligible for inclusion in supplementary capital; and exemption of dinar liabilities under deposits and loans received from abroad in the period 1 October 2008–31 March 2010 until their original maturity, but no later than 31 December 2013;

– repealed some exemptions – investments and loans deducted from the reserve base;

– unified and lowered the dinar and foreign currency required reserve ratio to 5% and 25%, respectively;

– comprised no provisions on the calculation and allocation of foreign currency required reserves against balances kept by leasing companies with banks, this being regulated by a separate decision.

The Decision provided for gradual harmonisation with the new reserve requirement ratios and encouraged bank activity both on the side of assets (bank lending) and liabilities (deposit accumulation and foreign borrowing).

To offset significant effects of the release of foreign currency required reserves and the repealing of some deductibles relating to bank lending, the new model of calculating reserve requirements was planned for introduction after one year transition period.

To promote the International Savings Day (31 October) and provide a further boost to household dinar savings, the NBS adopted a new set of amendments to the Decision on Required Reserves.

The said amendments provided for reserve requirement exemption of time dinar savings deposited during the "Savings Week", i.e. 1–8 November 2010, until the end of their deposit term.

Operations in the foreign exchange market

Consistent with inflation targeting, the NBS implements a managed float exchange rate regime, retaining the right to intervene in the foreign exchange market in order to ease excessive daily volatility of the exchange rate, to bolster trading volumes, and to contain threats to financial and price stability.

In 2010, the NBS sold EUR 2,569.7 mln to banks and bought from them EUR 236.5 mln.

During Q1 2010, the dinar weakened against the euro by 3.9% in nominal and 2.3% in real terms. The NBS intervened in the foreign exchange market (EUR 631.5 mln) in a bid to ease excessive daily volatility of the dinar and/or to boost trading volumes so as to ensure smooth functioning of the market.

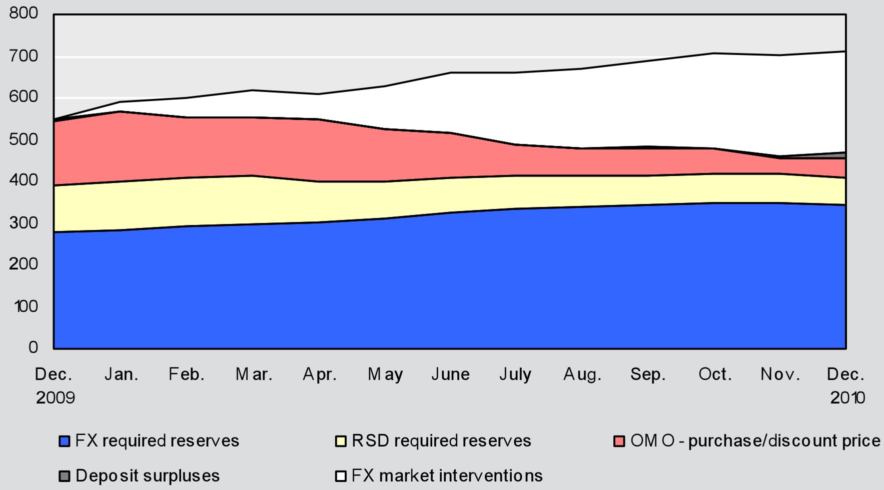
After the exchange rate stabilised in April when the NBS sold EUR 5 mln, strong depreciation pressures emerged in May as a result of a (region-wide) rise in the country risk premium triggered by investors' negative perception of the fallout from the sovereign debt crisis in some eurozone members.

The NBS sold another EUR 1,933.2 mln from May until the end of the year. Apart from intervening on the sale side, the NBS also acted as the buyer of foreign exchange – it bought EUR 10 mln in August amid short-term appreciation pressures and as much as EUR 226.5 mln in December. The domestic currency strengthened at the close of the year reflecting increased foreign exchange inflow from nonresidents in the wake of an upgrade in credit rating outlook from "negative" to "stable" (Fitch Ratings) and a decrease in the risk premium against the background of an elevated key policy rate.

At end-2010, the dinar depreciated against the euro by a nominal 9.1% and by a real 1.9% relative to end-2009.

The NBS implemented interventions via the *Reuters Dealing System* and by organising FX spot auctions. In its

Chart II.2.3. Volume of sterilisation by monetary policy instruments
(RSD bln)



Source: NBS.

interventions via the *Reuters Dealing System*, the NBS acted as the price taker, selling EUR 1,575 mln and buying EUR 125 mln. The NBS participated in spot auctions also as a price taker. Spot auctions were organised at the variable method – multiple exchange rate of the dinar against the euro, and the NBS sold EUR 994.7 mln and bought EUR 111.5 mln.

Foreign exchange swaps

Two-week foreign exchange swaps, introduced in May 2009 as one of the special financial stability support measures, were organised in 2010, but banks showed no interest in this type of foreign exchange purchase/sale.

In the period April–July 2010, the NBS organised three-month foreign exchange swaps, using them as a regular instrument of foreign exchange/dinar liquidity supply. The NBS aimed to encourage interbank swap trading and the development of the FX hedging market. At 28 swap auctions, organised under market conditions but with limited supply, the NBS sold EUR 109.2 mln and bought EUR 152.5 mln.

Auctions of short-term dinar loans

In 2010, the NBS continued organising monthly auctions of short-term loans in order to supply banks with dinar liquidity and thus contribute to the country's overall financial stability. At 12 auctions that were organised, short-term loans were approved at two auctions only, in the total amount of RSD 551.3 mln.

Other interest rates

Other interest rates charged by the NBS on loans, other investments and receivables, and paid on banks' balances with the central bank are prescribed by the *Decision on Interest Rates Applied by the National Bank of Serbia in Implementation of Monetary Policy*. The said decision was supplemented in March 2010 with a provision determining the level of the interest rate charged by the NBS on the amount of difference between the calculated and actual average daily balance of allocated leasing required reserves, and on the amount of difference between the prescribed and calculated amount of leasing required reserves during the maintenance period. To reflect these supplements, the *Decision on the Manner of Calculation, Collection and Payment of Interest by the National Bank of Serbia* was amended accordingly.

The ratio of the NBS discount rate to the key policy rate was changed in late March from 85% to 90% and in mid-May from 90% to 100%.

3. Implementation of inflation targets in 2010

Direction of y-o-y inflation changed in H2 2010. After moving below the lower bound of the target tolerance band during the first part of the year, inflation began rising by mid-year and finally overshot the upper bound of the target in October. The rise in y-o-y inflation continued over the next two months to reach 10.3% at year-end (target 6±2%).

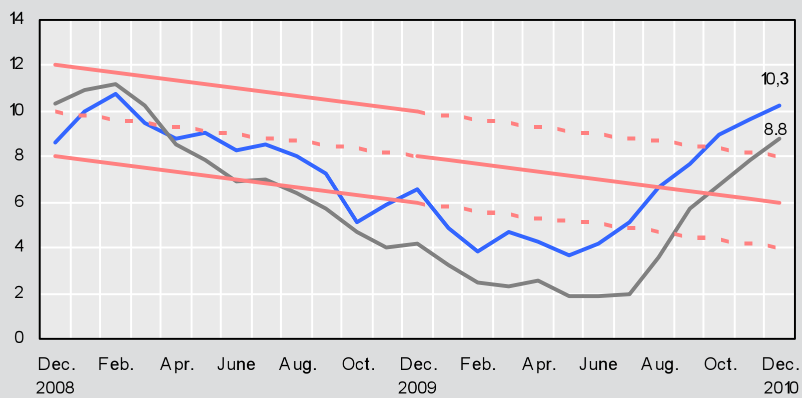
From 6.6% in December 2009 (target 6–10%), y-o-y inflation fell to 4.2% in June 2010 (target 7±2%) reflecting movement in core inflation, which decelerated in H1 from 4.1% in December 2009 to 1.9% in June 2010.

The decline in y-o-y inflation in H1 resulted primarily from two factors – low aggregate demand and lower food prices. The drop in aggregate demand was due to several reasons. First, economic downturn, caused by lower external demand in a crisis environment, weighed down on the financial position of the private sector, slashing employment and wages and limiting investment opportunities. Second, lower inflows from abroad and strained supply of domestic credit also contributed to the decline in investment and consumption. And third, lower fiscal revenue, resulting from a decline in economic activity, instigated implementation of restrictive income policy, mainly through the freeze on public sector wages and pensions.

Besides depressed aggregate demand, the target undershooting was also occasioned by an unanticipated decline in food prices. A relatively good harvest of 2009 and satisfactory supply of agricultural products in the domestic market paved the way for the lowering of agricultural product prices. This, together with low aggregate demand, caused a decline in processed food prices during the closing months of 2009 and H1 2010.

The consumer price rise in H1 2010 by 4.5% was determined primarily by movements in regulated (2.1 pp contribution to headline inflation) and agricultural product prices[6] (1.9 pp contribution). The strongest contribution to headline inflation came from higher prices of electricity, cigarettes and petroleum products. In

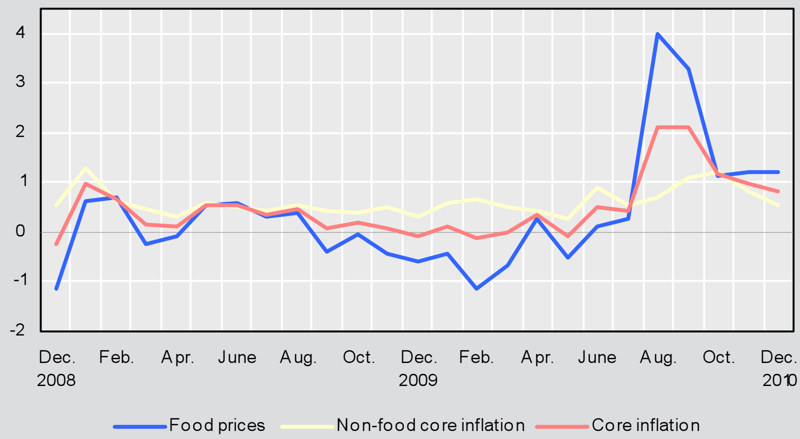
Chart II.3.1. Inflation movements
(y-o-y growth, %)



Source: Statistical Office and NBS.

[6] Agricultural products within the consumer basket, i.e. fruits and vegetables, eggs and fish.

Chart II.3.2. Core inflation by component
(monthly growth, %)



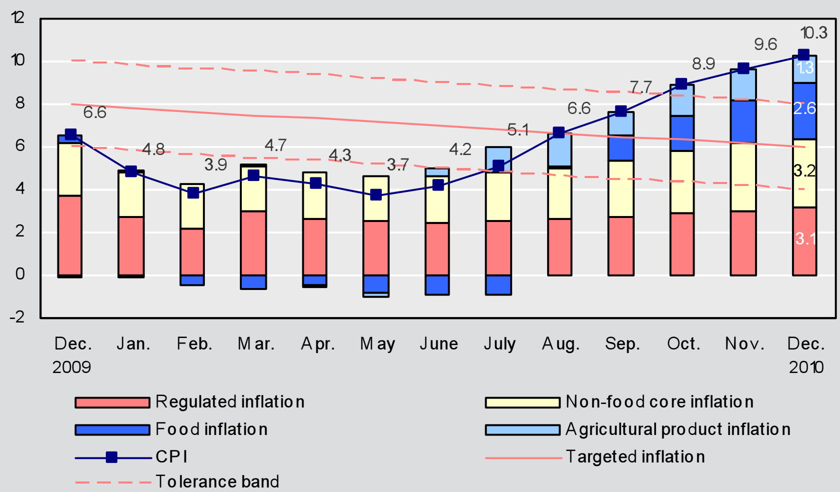
Source: NBS.

addition, the increase in agricultural product prices was somewhat higher than seasonally expected. On the other hand, the disinflationary effect generated by processed food prices was reflected in much lower core (0.8%) relative to headline inflation.

From mid-2010 onwards, y-o-y inflation trended up, overshooting the target tolerance band in October. Inflationary pressures were to a large measure generated by a strong rise in food prices (processed food and agricultural products). Inflation growth was also aided by the past depreciation of the dinar and higher inflation expectations.

Of the 6.1 pp rise in y-o-y inflation in H2 2010, 4.5 pp was attributable to food prices. Relative to H1, food

Chart II.3.3. Contribution of CPI components to y-o-y inflation
(in percentage points)



Source: NBS.

prices experienced complete reversal in terms of contribution to y-o-y inflation. The reversal was first registered for agricultural product prices (June) and then for processed food prices (August). Food price growth was due to a poor harvest worldwide, which resulted in higher global food prices. The share of food prices in Serbian CPI being rather high (37.8%), domestic inflation is highly sensitive to changes in prices of this group of products. Besides, due to an inadequate systemic framework, volatility of food prices is higher relative to the rest of the region, leading to their much higher growth in H2.

Though smaller, a transient contribution to inflation also came from the weakening of the dinar in May–June 2010 (through higher import prices). The weakening of the domestic currency may for its major part be put down to the eurozone sovereign debt crisis that overshadowed the region and led to a rise in risk premiums of South Eastern European countries, Serbia included.

The rise in consumer prices in H2 (5.5%) was fuelled mainly by the increase in prices of processed food within core inflation (11.7%). Besides, due to a relatively low agricultural output, the decline in agricultural product prices was much smaller than usual.

As the character of inflationary pressures was ultimately determined by food market volatility, besides employing measures to prevent the pass-through effect from the agricultural shock, the NBS initiated adoption of systemic measures and activities to stabilise the market in the medium run.

Table II.3.1. **Growth and contribution to annual CPI growth, by component, 2010**

	Growth rates (%)	Contribution (pp)
Total	**10.3**	**10.3**
Core inflation	**8.8**	**5.8**
Agricultural products	**17.4**	**1.3**
Regulated prices	**12.0**	**3.1**
Electricity	11.5	0.8
Petroleum products	12.3	0.6
Utilities-housing services	0.0	0.0
Social welfare services	22.9	0.6
Transportation services (regulated)	6.5	0.0
Postal and telecommunications services	4.2	0.0
Bread T-850	0.5	0.0
Cigarettes	7.3	0.0
Milk	16.3	0.6
Medicaments	10.2	0.3
Other	14.3	0.1

Source: Serbian Statistical Office and NBS.

III. Macroeconomic environment

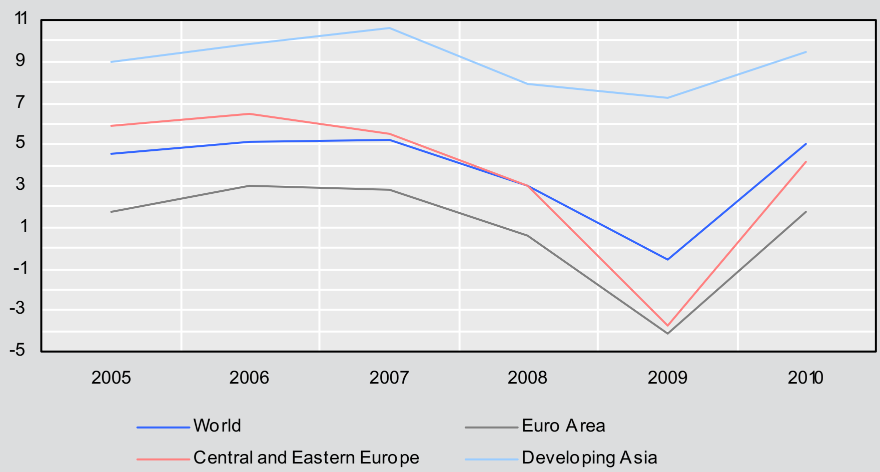
1. International environment

The recovery of the global economy in 2010 was solid, but unevenly spread across countries and regions. Emerging economies grew strongly, while those advanced continued to suffer the effects of the crisis such as high unemployment, sluggish economic growth, low investment activity and depressed consumer demand.

The US economy expanded by 2.8% in 2010, and though this growth may be considered solid, it was not sufficient to close the yawning negative output gap, let alone solve the problem of high unemployment. The unemployment rate drifted only slightly from its peak recorded in October 2009 (10.1%) to 9.4% in December 2010. The eurozone experienced an unevenly-paced and much weaker growth than the United States (1.7%). The strongest growth was registered in Germany, whose export-oriented industry capitalised on the weakening of the euro and buoyant demand from emerging markets. Positive developments were also seen in France, where investment climate improved, but unemployment remained high. Opposite trends were recorded in Greece and Ireland, which found themselves in deep financial troubles amid rocketing public debt. The engine of Asian economic growth was China (10.3%). Robust demand from this country contributed to the growth of export-oriented South East Asian economies. Japan's economy grew 3.9% thanks to exports and domestic demand stimulated by the government.

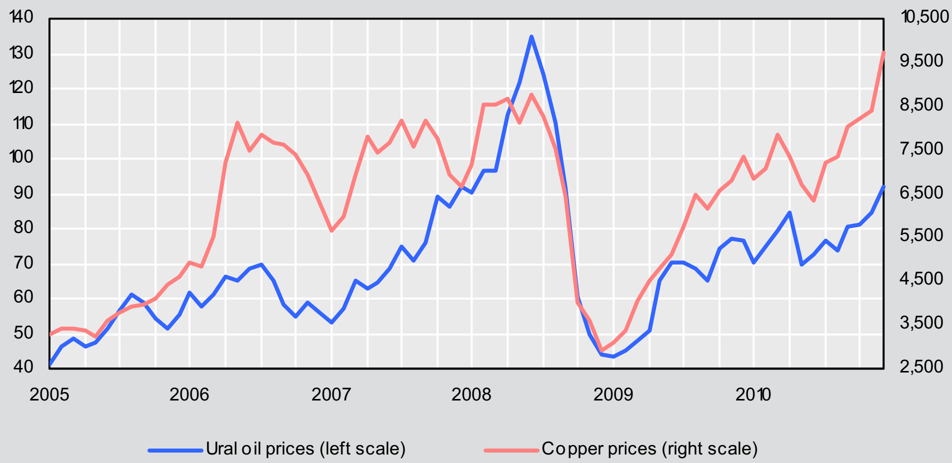
In 2010 the eurozone faced strong headwinds from the debt crises in Greece, Ireland, Portugal and Spain, whose mounting budget deficits and public debt brought into

Chart III.1.1. Economic activity by region
(GDP growth rates, %)



Source: NBS.

Chart III.1.2. Oil and copper prices
(US dollars)



Source: *Bloomberg.*

question their long-term solvency. The yields on sovereign bonds soared, access to new borrowing tightened and a crisis of confidence erupted, threatening to spread to other eurozone members. In mid-May 2010, the European Financial Stability Facility, worth around EUR 450 bln was established to help the imperilled countries. Greece and Ireland used a part of these funds in 2010. The sovereign debt crises took toll on the single European currency, leading to its decline against the world's major currencies, and most against the Swiss franc.

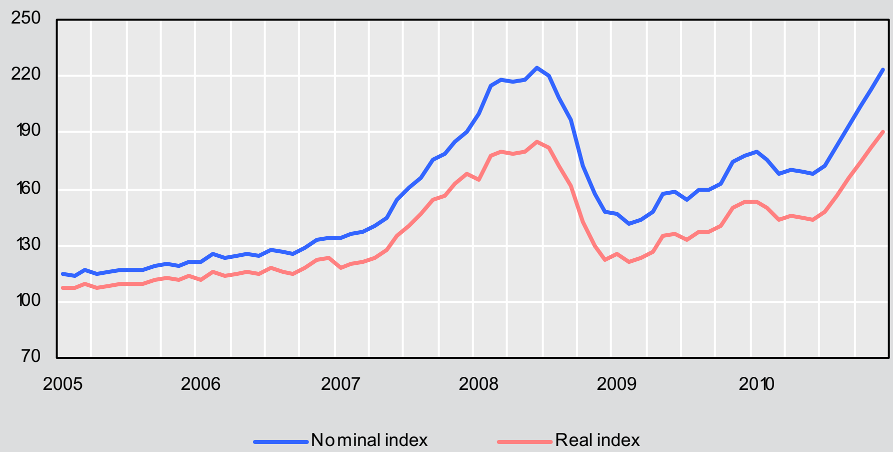
Emerging economies faced the global crisis with solid public finance, which gave them plenty of scope for further implementation of accommodative fiscal policies in 2010. Most advanced economies also continued running accommodative fiscal policies despite heightened pressure on public finance consolidation (due to high deficits and mounting public debt). Nonetheless, the debt crisis forced some eurozone countries to introduce stringent austerity measures.

Driven by the rising food and energy prices, y-o-y CPI inflation increased in most countries. In emerging markets, inflation growth was also propelled by the robust economic growth and the narrowing of negative output gaps. Though headline inflation reared its head in advanced economies, core inflation remained at bay. This induced the US and UK monetary authorities to conclude that the rise in food prices was only temporary and that the monetary policy stance should not be tightened.

During the first three quarters of 2010, oil prices were moderately high and moved within the range of USD 65–88 per barrel, exhibiting no major fluctuations as a result of sluggish growth of advanced economies and good market supply. It was not until the last quarter that oil prices rose substantially, exceeding the level of USD 90 per barrel, on the release of better than expected global growth data and the signs of impending political upheaval in North Africa. The rise in food prices was an important contributory factor to the growth in headline inflation in most countries in the second half of the year. From July 2010, the FAO Food Price Index trended upwards for eight consecutive months.

Central banks of the majority of advanced countries continued implementing accommodative monetary policies in 2010. Against the background of low inflation and high unemployment, the Fed kept its policy rate record low at 0.25%. Besides, in early November the Fed embarked on the second part of the quantitative easing programme, envisaging the purchase of USD 600 bln worth of Treasury bonds by mid-2011. The ECB policy rate, lowered to 1% in mid-2009, was kept on hold in 2010. It was at this rate that the ECB provided to banks unlimited auction loans. With a view to contributing to the stability of financial markets, from May onwards the ECB bought sovereign debt bonds issued by the financially troubled eurozone members, but decided not to extend the collateralised bond purchase programme that expired in June. The Bank of Japan continued implementing zero rate policy. It intervened in the foreign exchange market in September 2010 in a bid to

Chart III.1.3. Global food prices index
(2002 – 2004 = 100)



Source: FAO, UN.

stem the yen's strength, and announced in October that it would keep the benchmark rate at zero level until the drop in prices is halted. On the other hand, faced with strong economic growth and heightened inflationary pressures, the central banks of emerging market economies started tightening their monetary policy stance. The exception in this respect were East European countries, where central banks pursued expansionary monetary policies throughout the year in an environment of feeble economic growth. In 2010, the Central Bank of the Republic of China raised its policy rate and reserve requirements. It also introduced some administrative measures to curb excessive credit growth and allowed its currency to appreciate against the dollar by around 3.5%.

2. International transactions

Balance of payments trends and FX reserves

Against the backdrop of gradual global economic recovery, Serbia's balance of payments position in 2010 featured the continuation of current account deficit and its share in GDP at 2009 levels, including a reduction in deficit on trade in goods, further contraction in FDI inflow, enterprise external debt repayment, an increase in the disbursement of bank long-term loans and a decline in NBS FX reserves.

As deficit on trade in goods narrowed, current account deficit remained broadly unchanged from 2009 (c. EUR 2,080 mln or 7.2% of GDP). Deficit on trade in goods declined (6.7%) reflecting much faster growth in exports (23.8%) than imports (9.7%), while the imports to exports ratio rose by 7 pp to 60.8%. Such growth in exports was prompted by the recovery of demand in exporting markets, mainly the EU market, as well as by rising prices of our export goods in the world market and weakening of the dinar. Imports were affected by declining domestic demand and strained access to borrowing in the global financial market.

A rise in foreign trade reflected on the gradual recovery of services revenue, resulting in a positive balance of services in 2010 (EUR 5 mln).

Interest earnings on deposits and securities contracted by EUR 36 mln mainly due to a reduction in NBS FX reserves, while the inflow on account of profit earned abroad declined by EUR 17 mln. Payment of regular interest on foreign loans rose slightly (EUR 9 mln), but the repatriation of profits abroad rose by EUR 96 mln. This impacted on a EUR 167 mln (33.3%) increase in the negative balance. Net current transfers (mainly remittances) of EUR 3,356 mln fell by 4.6% and the coverage of the deficit on the balance of goods and services and interest to the net inflow of funds under current transfers (61.7%) was somewhat smaller than in 2009 (62.8%).

Table III.2.1. **Serbia's balance of payments**
(EUR mln)

	2009	2010
CURRENT ACCOUNT – BALANCE	-2,084	-2,082
CURRENT TRANSACTIONS BEFORE GRANTS – BALANCE	-2,282	-2,275
1. Goods (1.1 – 1.2)	-5,119	-4,773
1.1. Exports of goods f.o.b	5,978	7,403
1.2. Imports of goods f.o.b.	-11,096	-12,176
2. Services (2.1 – 2.2)	18	5
2.1. Receipts	2,500	2,667
2.2. Expenditure	-2,482	-2,662
3. Balance of goods and services (3.1 – 3.2)	-5,100	-4,768
3.1. Exports of goods and services	8,478	10,070
3.2. Imports of goods and services	-13,578	-14,838
4. Income	-503	-670
4.1. Receipts	500	438
4.2. Expenditure	-1,002	-1,108
5. Current transfers	3,518	3,356
5.1. Receipts	3,762	3,624
5.2. Expenditure	-244	-268
CAPITAL ACCOUNT	2	1
FINANCIAL ACCOUNT	2,207	2,032
1. Direct investment – net	1,373	860
1.1. Abroad (claims)	-38	-143
1.2. In Serbia (liabilities)	1,410	1,003
2. Portfolio investment – net	-51	39
2.1. Assets (claims)	-5	-30
2.2. Liabilities (liabilities)	-46	69
3. Other investments	3,249	204
3.1. Assets (claims)	75	-788
3.2. Liabilities (liabilities)	3,174	992
4. Reserve assets	-2,364	929
ERRORS AND OMISSIONS	-124	49
OVERALL BALANCE	2,363	929

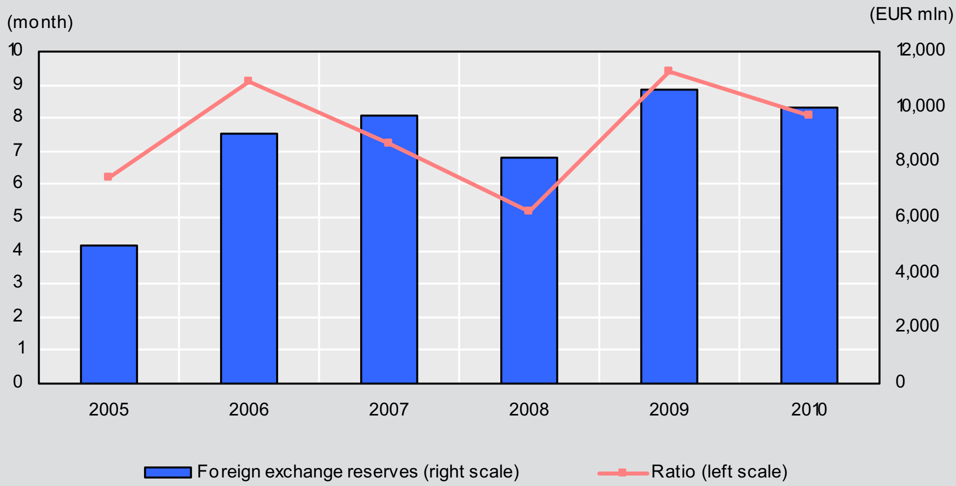
Source: NBS (ITRS), Statistical Office.

FDI contracted by EUR 407 mln relative to 2009. Dominant in the FDI structure were investments in manufacturing (33.7%), mainly the production of processed food and beverages and the production of base metals. Investment in financial intermediation accounted for 28.4%, trade – 19.3%, and real estate activities – 17.6%. Under portfolio investment, foreign capital withdrawal, recorded in 2009, came to an end. In 2010, net foreign capital inflow amounted to EUR 39 mln.

Other investment (loans and deposits) fell sharply relative to 2009 (from EUR 3,249 mln to EUR 204 mln net) due to lower disbursement of IMF loans (EUR 787 mln), SDRs (EUR 422 mln), short-term financial loans (EUR 245 mln) and short-term commodity loans (EUR 562 mln), as well as due to an increase in regular long-term loan repayments – especially with banks (EUR 349 mln) and increased banks' FX reserves (EUR 389 mln) which declined by EUR 445 mln in 2009.

With IMF loans excluded, net disbursement of financial loans came at double the amount recorded in 2009 but exclusively in response to a EUR 477 mln increase in net disbursement of long-term government loans. Banks net disbursed EUR 652 mln in long-term loans hence improving the maturity structure of their external debt, while enterprises registered a net capital outflow of EUR 789 mln.

Chart III.2.1. Ratio of FX reserves to imports



Source: NBS.

Capital inflow was smaller than the current account deficit, which impacted on trends in the FX market and the dinar exchange rate. NBS FX reserves declined by EUR 929 mln under the balance of payments methodology or by EUR 600 mln calculated at the current exchange rate.

At end-2010, **NBS FX reserves** stood at EUR 10,002 mln, providing the M1 coverage of 417% and around 8 months of imports of goods and services.[7]

Dominant in the FX reserves structure were again securities (83.9%), followed by a much smaller share of funds in accounts abroad (9.7%), gold and SDR (4.5%) and foreign cash (1.9%).

In 2010, NBS FX reserves were boosted by EUR 203.2 mln. The inflow under the disbursement of RS loans came at EUR 994.3 mln.[8] Further, a EUR 344.1 mln inflow was recorded against the disbursement of IMF loans and EUR 270.4 mln against temporary payment operations with Kosovo and Metohija. Banks net allocated EUR 328.8 mln in required reserves (EUR 678.0 mln in 2009). Grants came at EUR 131.1 mln, of which the EU macrofinancial aid totalled EUR 50.0 mln. In regard to privatisation, a EUR 4.6 mln inflow was recorded after activation of three guarantees due to the termination of company sale agreements. An outflow from FX reserves resulted from FX market interventions of EUR 2.4 bln, settlement of due liabilities towards foreign creditors of EUR 394 mln, payment of frozen FX savings and obligations under the economic development loan of EUR 228.9 mln.

In 2010, the NBS complied with the NFA floor criterion stipulated by the IMF's Memorandum of Understanding – at end-December, NFA reached EUR 4,944 mln calculated by the IMF's program exchange rate[9] (the floor was EUR 4.000 mln).[10]

Country's international investment position

At end-2010, external financial obligations of Serbia's residents exceeded the value of financial assets they invested abroad by EUR 24,889 mln, which represents 83.3% of GDP.

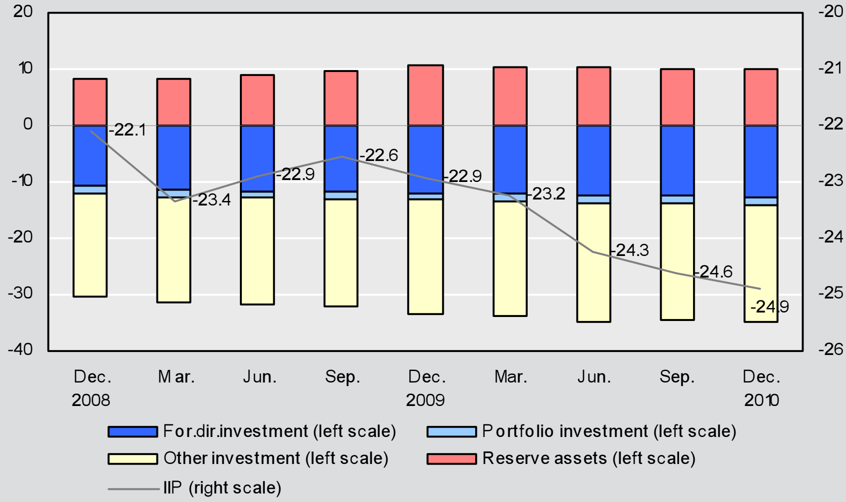
[7] The ratio of end-2010 FX reserves to the average monthly imports of goods and services over 2010.

[8] The EIB – EUR 261.3 mln (for the development of SMEs, the City of Belgrade, reconstruction of roads and bridges and the municipal and regional infrastructure); Russian Federation – EUR 157.5 mln (for the macrofinancial budget support); World Bank – EUR 140.6 mln (for the development of public finance, private and financial sectors); Eurofima – EUR 6.3 mln; local and foreign banks – EUR 428.6 mln (for budget deficit financing).

[9] The exchange rate of 11 March 2009. Calculated under the exchange rate of 31 December 2010, NFA amounted to EUR 5,073 mln at end-December.

[10] For end-March 2010, the NFA floor under the program was EUR 4,000 mln vs. recorded EUR 6,103 mln; end-June floor: EUR 4,900 mln vs. recorded EUR 5,442 mln; end-September floor: EUR 4,600 mln vs. recorded EUR 5,003 mln.

Chart III.2.2. International investment position
(EUR bln)



Source: NBS.

Relative to end-2009, Serbia's negative international position deteriorated by further EUR 1,960 mln or 6.8 pp of GDP. This came about as a result of capital inflow under transactions performed (EUR –1,951 mln), valuation changes (EUR –461 mln) reflecting strengthening of the dollar against the euro, rising value of monetary gold and securities in reserve assets (EUR +149 mln) and other changes arising from the

Table III.2.2. **Serbia's international investment position**
as at 31 Dec. 2010
(EUR mln)

	Assets	Liabilities	Stock
1. Direct investment	**2,958**	**15,780**	**-12,822**
1.1. Equity capital	2,958	12,983	-10,025
1.2. Other capital	0	2,798	-2,798
2. Portfolio investment	**77**	**1,427**	**-1,351**
3. Financial derivatives	**n/a**	**n/a**	**n/a**
4. Other investment	**2,904**	**23,622**	**-20,718**
4.1. Other equity	0	0	0
4.2. Cash and deposits	2,687	461	2,226
4.3. Loans	167	22,583	-22,415
4.3.1. National Bank of Serbia	0	1,603	-1,603
4.3.2. Public sector	0	6,269	-6,269
4.3.3. Banks	137	5,093	-4,956
4.3.4. Other sectors	30	9,617	-9,587
4.4. Financial leasing	0	0	0
4.5. Insurance and pensions	0	0	0
4.6. Trade credits and advances	49	128	-79
4.7. Other accounts receivable/payable	0	0	0
4.8. Special drawing rights	-	449	449
5. Reserve assets	**10,002**	**-**	**10,002**
TOTAL (1+2+3+4+5)	**15,940**	**40,829**	**-24,889**

Source: NBS.

write-off, revaluation, reclassification, creation or termination of obligations not stemming from transactions (EUR +303 mln).

The net position structure remained broadly unchanged from 2009. Net other investment accounted for the largest share (EUR 20,718 mln), followed by direct investment (EUR 12,882 mln) and portfolio investment (EUR 1,351 mln), while reserve assets amounted to EUR 10,002 mln.

Foreign financial assets, i.e. financial assets of Serbia's residents abroad declined by EUR 66 mln to EUR 15,940 mln by the year-end. Changes arising from settlement of trade debt via compensation, set-offs, etc. ('other changes') reached EUR –530 mln, while capital outflow under transactions performed was positive at EUR 51 mln. Also positive were valuation changes and changes in prices of instruments in reserve assets (EUR 413 mln).

The balance of FDI of residents abroad rose by EUR 210 mln, portfolio investment by EUR 32 mln, and local bank reserves abroad by EUR 421 mln. A reduction was recorded with the country's FX reserves by EUR 600 mln, trade credits by EUR 119 mln and claims under loans extended to non-residents by EUR 8 mln.

Foreign financial liabilities, i.e. residents' external financial liabilities rose by EUR 1,895 mln to EUR 40,829 mln at end-2010, in response to capital inflow under transactions performed (EUR 2,002 mln) and valuation changes (EUR 725 mln), while other changes were negative (EUR –833 mln).

Non-residents' FDI rose by EUR 1,134 mln, portfolio investment by EUR 107 mln and debt under foreign loans by EUR 1,326 mln.

External debt

Republic of Serbia's external debt amounted to EUR 23,786 mln at end-2010, up by EUR 1,299 mln relative to end-2009. Its share in GDP rose by 4.7 pp, reaching 82.5% by the year-end. The increase was due to rising public external debt and banking sector external debt. At the same time, the euro lost 7.4% against the US dollar, meaning that euro-denominated debt rose by EUR 470.3 mln on account of euro's depreciation.

In 2010, public sector external debt[11] rose by EUR 1,313 mln to EUR 9,076 mln at the year-end, making up 38.2% of total debt. In contrast, the private sector cut its external debt by EUR 14 mln to EUR 14,710 mln at end-2010 or 61.8% of total debt.

Private sector external debt declined against enterprise external debt repayment. At end-2010, enterprise external debt amounted to EUR 9,617 mln, down by EUR 796 mln on end-2009. The banking sector external debt reached EUR 5,093 mln, up by EUR 783 mln. Banks' long-term debt rose the most – by EUR 765 mln to EUR 3,362 mln. A step-up in banks' borrowing under short-term deposits and credit lines is customary for a year-end – the stock of debt reached EUR 1,731 mln, which is a EUR 18 mln increase on end-2009.

Broken down by sector, external debt in the financial intermediation sector rose by EUR 744.6 mln, followed by transport and storage (EUR 65.1 mln) and mining (EUR 23.2 mln). A decline was noted in manufacturing (EUR 279.3 mln), financial leasing (EUR 206.8 mln), information and communications (EUR 157.9 mln), wholesale and retail trade (EUR 65.3 mln), construction (EUR 43.4 mln), real estate (EUR 43.0 mln) and ancillary catering services (EUR 37.3 mln).

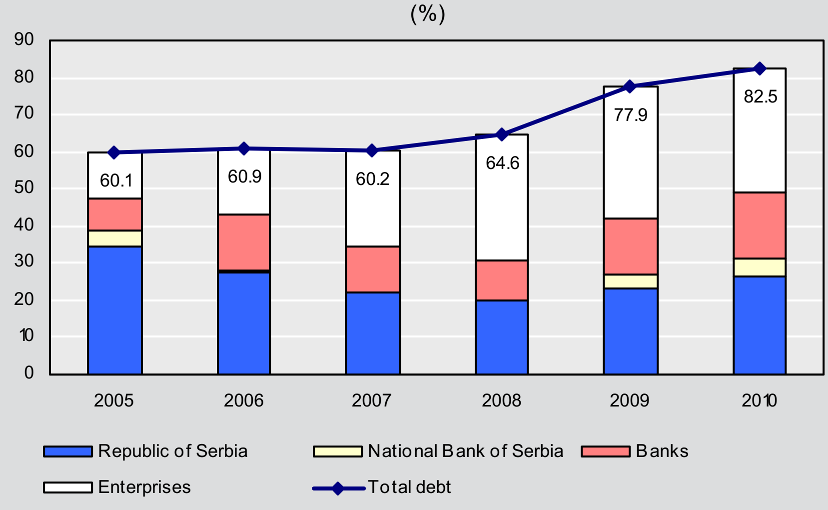
At end-2010, the external debt currency structure comprised the euro – 76.4%, the dollar – 10.0%, SDR – 8.3%, the Swiss franc – 4.6%, and the clearing dollar – 0.1%. Other currencies accounted for 0.6%.

The external debt maturity structure improved further in 2010 as the share of long-term debt rose to 92.3%. External liquidity indicators improved as well – the ratio of external debt to exports of goods and services fell by 29.1 pp to 236.2%, and the ratio of external debt to exports of goods and services and remittances[12] declined by 10.5 pp to 181.3%. Furthermore, the ratio of total external debt repayments to exports of goods and services fell to 33.8% (including remittances, the share of repayments declined to 28.1%).

[11] Pursuant to the IMF's methodology, the Republic of Serbia's external debt also includes public debt liabilities, which, in addition to the old rescheduled debts and new government borrowings, encompass NBS liabilities, non-regulated RS liabilities including clearing debt, as well as a portion of debt of local governments and state agencies that is not government-guaranteed.

[12] Within external liquidity indicators, debt repayments can be analysed in relation to exports of goods and services, inclusive of remittances that represent a stable and significant inflow. The same applies to external debt within external solvency indicators.

Chart III.2.3. Republic of Serbia's external debt by debtor relative to GDP
(%)



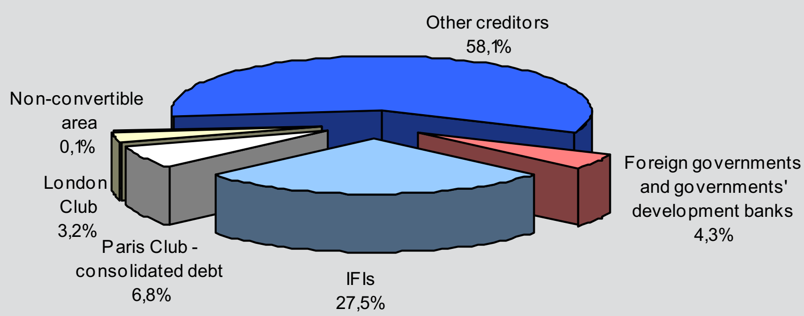
Source: NBS.

By end-December 2010, debt to international financial organisations made up 27.5% of the total. Consolidated debt to the Paris Club and London Club creditors equalled 6.8% and 3.2% of the total. Debt to foreign governments and development banks of foreign governments accounted for 4.3%. More than half of the debt (58.1%) related to foreign banks and other financial institutions, suppliers, strategic partners and other enterprises. Non-convertible currency debt (clearing) related to the non-regulated debt to foreign creditors from the former Czechoslovakia (0.1% of the total).

3. Trends in the foreign exchange market and the dinar exchange rate

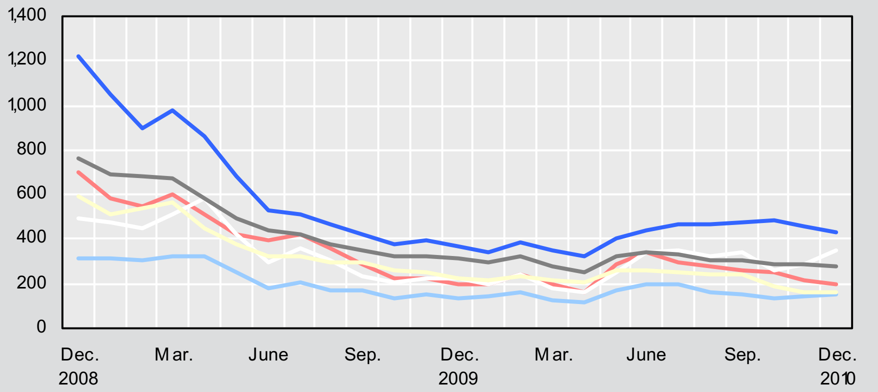
In 2010, the dinar lost 9.1% against the euro in nominal terms. This was triggered by elevated risk premium and the ensuing lower capital inflow. Depreciation pressures were the strongest in the May–July period. In May, owing to the sovereign debt crisis in some eurozone countries and investors' negative perception of the fallout of the crisis in Central and Eastern Europe, risk premium soared in these

Chart III.2.4. Republic of Serbia's external debt by foreign creditor
(as at 31 December 2010)



Source: NBS.

Chart III.3.1. EMBI by country
(monthly averages, basis points)



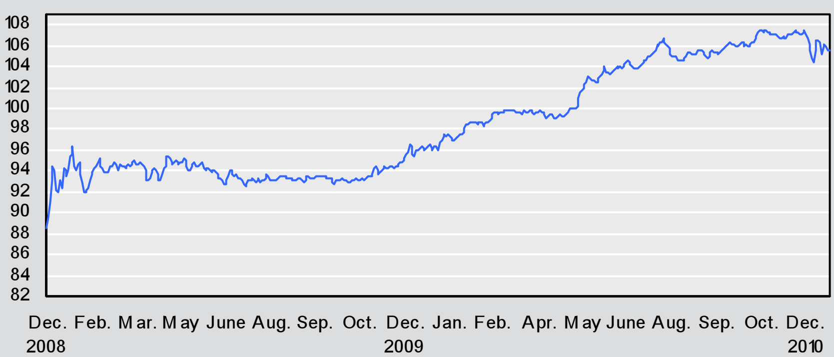
Source: JP Morgan.

countries (measured by EMBI[13]) and depreciation pressures mounted. Until October, Serbia's risk premium continued up, though at a slower pace. Since November when the Fitch rating agency raised Serbia's credit rating outlook from negative to stable, EMBI for Serbia has been declining.

By end-2010, depreciation pressures started waning. Stabilisation and later strengthening of the dinar were aided not only by declining risk premium, but also by higher remittances inflow, a step-up in FX purchases from non-residents and key policy rate hikes. In 2010, the NBS intervened in the IFEM by selling EUR 2.6 bln and purchasing EUR 236.5 mln. The average daily interbank trading in the IFEM (the NBS excluded) rose by c. 50% to EUR 42 mln from 2009.

In 2010, the dinar lost 15.8% against the dollar in nominal terms. As weakening of the nominal effective exchange rate of the dinar (10.5%)[14] was stronger than the growth in domestic relative to foreign prices, the real effective depreciation of the dinar equalled 3.1% (1.8% against the euro and 8.3% against the dollar).

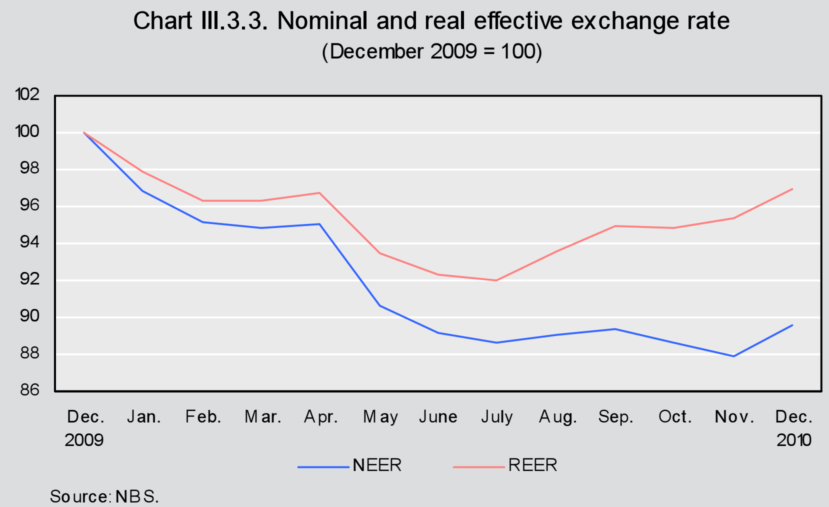
Chart III.3.2. Dinar vs. euro



Source: NBS.

[13] Emerging Markets Bond Index.

[14] Weights: 0.8 for the euro and 0.2 for the dollar.



4. Money market trends

Interest rates

In the major part of 2010, BEONIA trended below the key policy rate, overshooting the NBS rate in four months only. Its movements largely mirrored the volatility of banking sector liquidity. Therefore, monthly deviations of average BEONIA from the key policy rate ranged from -0.8 pp to 0.4 pp. Average daily trading volumes in the overnight market amounted to RSD 8.3 bln, up by 1.5% on 2009.

Up to 2-month BELIBOR rates however reflected movements in the key policy rate. A deviation was recorded in July only when BELIBOR rates rose slightly though the key rate remained flat. BELIBOR for 3- and 6-month maturity mirrored the effective rates on T-bills of the same maturity. The spread between the shortest and longest maturity BELIBOR varied significantly –

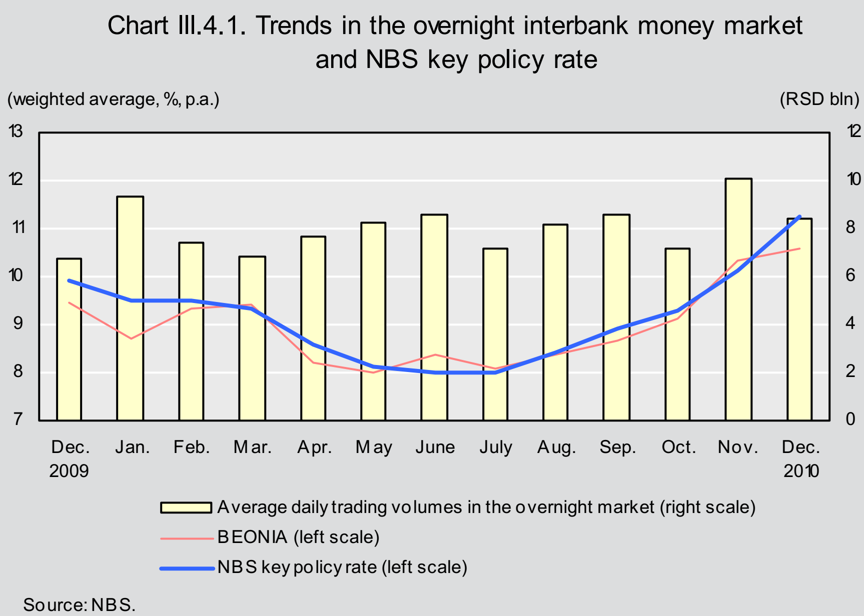
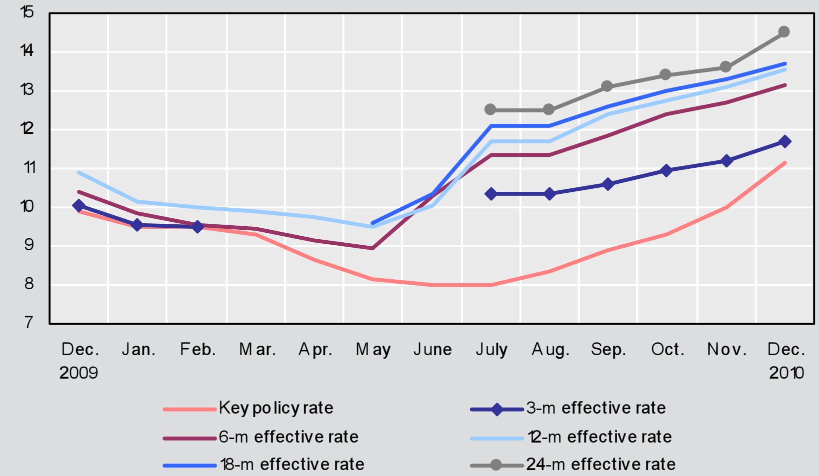


Chart III.4.2. Effective rates on T-bills and key policy rate
(weighted average, %, p.a.)



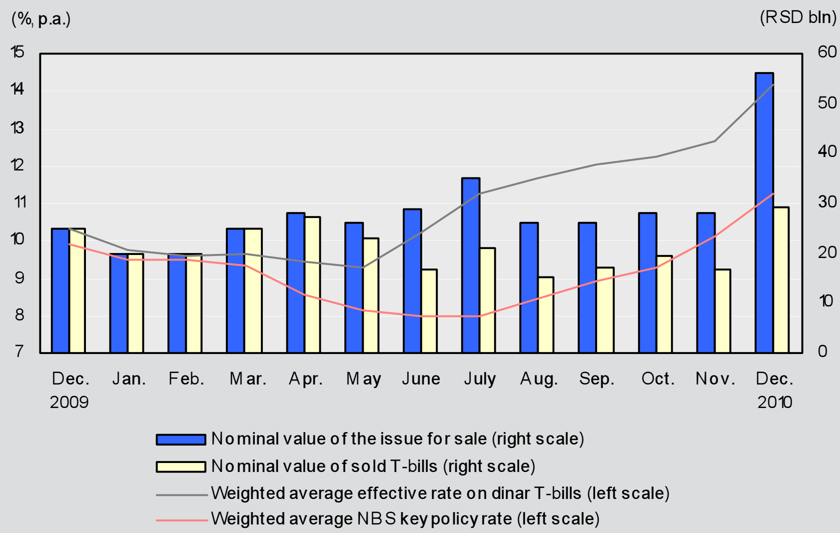
Source: Ministry of Finance and NBS.

from 0.4 pp by end-Q1 to 2.5 pp by end-Q3. Growth in 3- and 6-month BELIBOR was particularly strong in H2 – these rates reached 13.1% (3-month) and 13.6% (6-month) at the year-end, up by 2.1 pp and 2.6 pp relative to December last year. At the same time, the shortest-maturity BELIBOR (T/N) rose by 1.2 pp to settle at 11.7% in December 2010.

Following the issue of 3-, 6- and 12-month T-bills in 2009, the government has been issuing 18-month bills since May. In July, it kick-started 2-year T-bills, enabling the formation of a longer dinar yield curve.

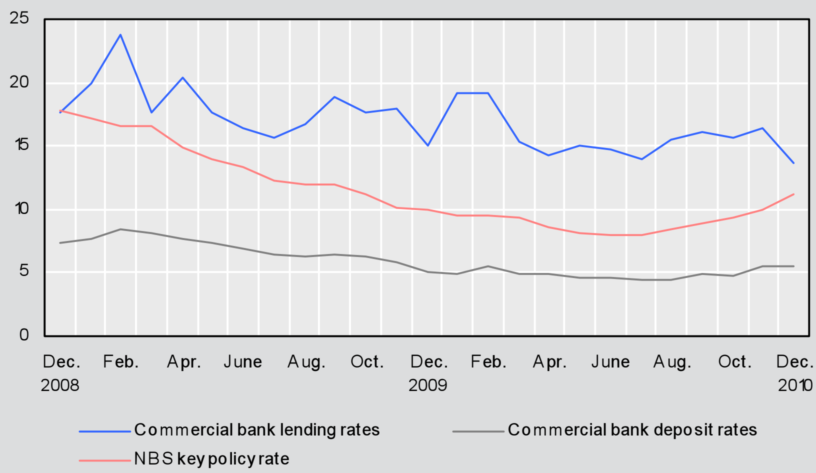
Monetary relaxation implemented until May 2010 brought about a decline in effective rates on T-bills. In February, effective rates on 3-month bills moved slightly below the key policy rate. The trend of T-bill effective rates reversed in May. Namely, the escalation of the fiscal crisis in some eurozone members triggered a global rise in risk premium, which affected Serbia as well. Since

Chart III.4.3. Trends in the primary market of government securities and key policy rate



Source: Ministry of Finance.

Chart III.4.4. Key policy rate and bank interest rates*
(weighted average, %, p.a.)



* Lending rates relate to FX-indexed and dinar loans.
Source: NBS.

August, monetary tightening induced a rise in effective rates that continued up until the year-end. By the year-end, the government issued first euro-indexed T-bills and sold them at a 5.25% rate.

Weighted average bank rates on newly extended corporate and household loans were declining throughout 2010. However, excluding the peak values recorded since early year and minimum values by the year-end, lending rates oscillated in 2010 at around 15%[15]. This signals a 2.5 pp y-o-y decline, prompted by a lower key policy rate and falling EURIBOR until mid-2010. Lending rates declined under the impact of a higher volume of lending at subsidised interest under the Government's Programme to Mitigate Adverse Effects of the Global Economic Crisis in Serbia.

Corporate and household deposit rates displayed much smaller volatility in 2010. A slight increase in deposit rates recorded by the year-end was prompted by more favourable terms offered by banks in the "Savings Week".

Monetary aggregates

Reserve money

Total reserve money rose by 0.7% nominally in 2010 and declined by 8.7%[16] in real terms. Dinar reserve money fell by RSD 66.1 bln, while foreign currency deposits of banks with the NBS rose by RSD 69.7 bln. Such trends resulted from the implementation of the new required reserves decision adopted in March 2010. The decision prescribes calculation of required reserves at unified rates and allocation of dinar required reserves in dinars and FX reserves in euros.

In 2010, reserve money was issued via the dinar and withdrawn via the FX channel.

NFA contracted by RSD 16.7 bln. Inflows into FX reserves did not suffice to cover the outflows prompted by IFEM FX sales to banks, settlement of government external obligations and liabilities under frozen FX savings, resulting in a EUR 600 mln decline in NBS FX reserves. Inflows resulted from loans extended to the government by domestic banks and the Russian Federation for budget deficit financing, from the withdrawal of four IMF loan tranches and funds allocated under FX required reserves.

A decline in bank investment in repo securities, chiefly motivated by more lucrative investment in T-bills, gave the strongest boost to the issue of reserve money via the dinar channel. To sterilise liquidity under the release of dinar required reserves, the NBS sold RS bonds issued in 2004, in the nominal amount of RSD 10.7 bln for the

[15] Lending interest rates are affected by the volume of banks' lending activity. High levels of lending rates may be explained by the seasonal decline in the early-year lending activity. Further, a fall in interest rates recorded in December was prompted by sharp growth in lending (three times stronger than in early year).

[16] Deflated by CPI.

Table III.4.1. **Balance sheet of the National Bank of Serbia**
(in RSD mln)

	Dec. 2009	Dec. 2010	Changes in 2010
Net foreign assets	**908,284**	**892,721**	**-15,563**
Net FX reserves	910,173	893,497	-16,676
Gross FX reserves	1,016,607	1,055,151	38,544
IMF loans	-106,434	-161,654	-55,220
Other net foreign assets	-1,889	-776	1,113
Net domestic assets	**-374,508**	**-355,382**	**19,126**
Net domestic NBS loans	-250,734	-149,570	101,164
Net loans to government[1)]	-100,939	-106,392	-5,453
Government loans	11,300	1,319	-9,981
Government deposits	-112,239	-107,711	4,528
Net claims on banks	-151,293	-46,504	104,789
Loans to banks	386	404	18
Repo operations	-151,676	-46,900	104,776
Other securities	-3	-8	-5
Loans to public enterprises	0	0	0
Loans to non-bank financial institutions	4,879	5,519	640
Loans to other sectors	2,463	3,404	941
Term and restricted deposits	-5,844	-5,597	247
NBS savings bills	0	0	0
Other net assets	-123,774	-205,812	-82,038
Reserve money	**533,776**	**537,339**	**3,563**
Dinar reserve money	254,268	188,162	-66,106
Currency in circulation	95,519	91,750	-3,769
Dinar reserves of banks	151,030	87,413	-63,617
Required reserves	111,874	65,079	-46,795
Excess reserves	39,156	22,334	-16,822
Other deposits of other sectors	1	1	0
Local government deposits	7,718	8,998	1,280
FX bank deposits	279,508	349,177	69,669

[1)] Excluding local government authorities.
Source: NBS.

settlement of government obligations to the NBS. The effect of this sale outweighed the decline in dinar deposits with the NBS, and the net government position prompted the reserve money withdrawal. A fall in other net assets, driven by valuation gains, was another factor behind the reserve money withdrawal.

The structure of dinar reserve money displayed the sharpest fall in bank reserves (RSD 63.6 bln) due to the contraction in dinar required reserves (RSD 46.8 bln). Banks' excess assets and cash in circulation declined by RSD 16.8 bln and RSD 3.8 bln on end-2009 respectively. Implementation of the new required reserves decision pushed up funds in banks' FX accounts.

Monetary aggregates M1, M2 and M3

Dinar monetary aggregates declined in 2010, while M3 continued up.

Relative to end-2009, money supply M1 lost 2.0% in nominal and 11.1% in real terms. A RSD 5.1 bln decline in M1 was driven by a fall in cash in circulation to a greater and a decline in funds in transaction accounts to a lesser extent.

Table III.4.2. **Monetary survey**
(RSD mln)

	Dec. 2009	Dec. 2010	Changes in 2010
Net foreign assets	**570,503**	**507,330**	**-63,173**
Bank net foreign assets	-337,781	-385,391	-47,610
Net domestic assets of the banking sector	**635,067**	**853,448**	**218,381**
Net domestic loans	1,301,660	1,722,550	420,890
Net claims on government	-4,419	65,644	70,063
Government loans	119,124	193,983	74,859
Government deposits	-123,543	-128,339	-4,796
Loans to other resident sectors	1,306,079	1,656,906	350,827
Loans to other financial institutions	18,775	35,433	16,658
Loans to the corporate sector	850,854	1,074,501	223,647
Loans to households	418,924	528,203	109,279
Loans to local government authorities	11,533	18,106	6,573
Loans to non-profit and other organisations	5,993	663	-5,330
Other net assets	-666,593	-869,102	-202,509
Money supply M3	**1,205,570**	**1,360,777**	**155,207**
Money supply M2	436,768	410,495	-26,273
Money supply M1	258,427	253,286	-5,141
Currency in circulation	95,519	91,750	-3,769
Transaction deposits	162,908	161,536	-1,372
Dinar savings and term deposits	178,341	157,209	-21,132
FX deposits	768,802	950,282	181,480

Source: NBS.

Application of the new Law on Enterprise Bankruptcy (bankruptcy proceedings are automatically initiated in enterprises whose accounts have been blocked for more than three years) gave the strongest impetus to a RSD 21.1 bln decline in dinar saving and term deposits. Household dinar saving did not rise to any large degree – together with a decline in M1, monetary aggregate M2 lost 6.0% in nominal and 14.8% in real terms.

M3 was the only aggregate that recorded a y-o-y rise – 12.5% in nominal and 2.3% in real terms. Growth in FX deposits was driven by rising household FX saving (EUR 1 bln in 2010), most notably over the "Savings Week" owing to favourable terms offered by banks during that week.

The M3 to NBS FX reserves ratio declined from 84.3% in 2009 to 77.5% in 2010, while the ratio to total banking sector FX reserves fell from 95.7% to 90.6%.

NDA acted in the direction of creation and NFA in the direction of M3 withdrawal. The greatest individual contribution to NDA creation came from bank corporate and household lending. The government net contribution was positive as well – borrowing via the sale of T-bills and borrowing in foreign currency to cover the budget deficit outweighed the effect of growth in total government deposits with the NBS and banks. The NFA negative contribution resulted from lower NFA of both the NBS and banks.

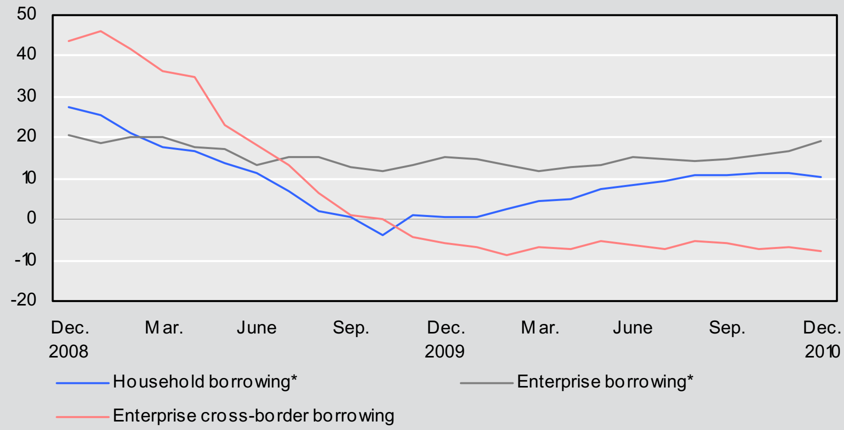
Bank lending

Reflecting the incipient economic recovery, growth in bank lending accelerated in 2010 relative to the previous year. The share of bank receivables under loans in GDP rose by 7.7 pp to 54.8%.

Corporate and household lending rose by 15.8%[17] in real terms – corporate loans: 19.0% and household: 10.5%.

[17] Deflated by inflation, excluding the effect of exchange rate volatility.

Chart III.4.5. Real bank claims under loans and enterprise cross-border borrowing
(y-o-y growth rates, %)



* Deflated by inflation, excluding the effect of exchange rate changes.
Source: NBS.

Bank claims on the non-financial sector rose by RSD 348.6 bln (27.2%) nominally, or RSD 222.3 bln (17.4%) excluding the effect of dinar volatility.

Banks generally tapped the domestic sources of finance. Growth in net external borrowing was another factor, though with a smaller impact, behind expansion in lending potential.

Liquidity maintenance still being a major issue of the Serbian economy, enterprises used mostly liquidity loans. Investment loans rose sharply as well, reflecting the nascent economic recovery. Broken down by sector, most loans were approved to enterprises in the fields of industry, trade and transport. Within household loans, the strongest growth was recorded with housing loans, followed by agricultural producer, as well as consumer and cash loans.

The dinarisation process promoted by the NBS yielded positive results in 2010 when the share of FX and FX-indexed in total loans declined by 5.9 pp to 69.5% by the year-end.

Programmes of loan subsidisation were further implemented in 2010 – banks approved almost EUR 2 bln in such loans. Most loans were extended within the Government's Programme to Mitigate Adverse Effects of the Global Economic Crisis (EUR 1.8 bln), with liquidity loans being predominant (67%). Due to strong demand for these loans, funds earmarked for interest subsidisation were spent before the year-end. To enable the continuation of the programme until end-2010, additional funds were approved under the budget revision. The subsidised segment of the market gave a significant contribution to lending, as confirmed by the share of subsidised in newly approved loans (17.1% on average).

Table III.4.3. **Subsidised loans in 2009 and 2010**
(RSD bln)

	2009	2010
Government's Programme of Measures to Mitigate Adverse Effects of the Global Financial Crisis		
Total	**104.8**	**185.1**
Liquidity	88.7	124.6
Investment	0.2	24.2
Consumer	15.9	9.2
Dinar cash		27.1
Subsidised housing loans	**2.1**	**13.2**

Source: Ministry of Economy and Regional Development, National Mortgage Insurance Corporation.

5. Aggregate demand

According to the Statistical Office estimate, Serbia's GDP grew 1.8% in 2010.

GDP growth was driven by rising foreign demand. Exports rose faster than imports, giving rise to sharp narrowing in foreign trade deficit. Such trends resulted in the positive contribution of net exports to GDP growth that outstripped the negative contribution of domestic demand.

Domestic demand

Domestic demand continued down in 2010, though at a slower pace than in 2009. Both final consumption and investments declined, but to a lesser extent than a year earlier. A slowdown in the decline in final consumption was prompted by mild recovery of household consumption and a slower cut in government spending. Within investment activity, equally negative contribution to GDP growth came from gross investment in fixed funds (both of the private sector and the government) and an increase in inventories.

Net external demand

Exports by far outstripped imports in 2010 (23.8% vs. 9.7%), owing primarily to the global economic recovery. Dominant in exports were food, base metals and chemical products. while, Italy, Bosnia and Herzegovina and Germany were the leading export markets. Intermediate products dominated imports.

Table III.5.1. **GDP expenditure side in 2010***

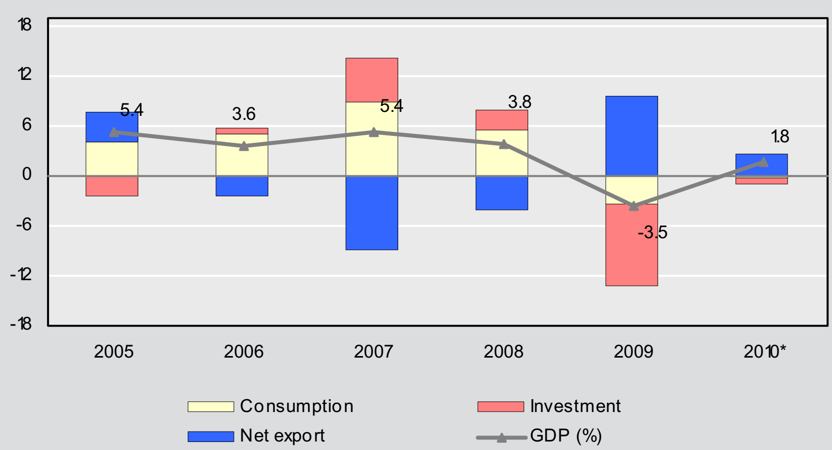
	Growth rates (%)	Contribution to GDP growth (pp)
GDP, at market prices	**1.8**	**1.8**
Domestic demand	-0.8	-1.0
Total final consumption	-0.2	-0.2
Investment	-3.7	-0.8
Net exports (exports – imports)	15.5	2.8

* NBS estimate.

6. Economic activity

GDP and non-agricultural value added (NAVA) are estimated to have grown by 1.8% and 2.3% in 2010 respectively. Economic growth was driven by the services sector (3.1%), notably transport, storage and communications. A pick-up was also recorded in the financial intermediation sector and real estate activities,

Chart III.5.1. Contribution to GDP growth – expenditure side
(in percentage points)



* Based on quarterly GDP data.
Source: Serbian Statistical Office and NBS.

Table III.6.1. **Economic activity in 2010**

	Growth rates (%)	Contribution to GDP growth (pp)
GDP, at market prices	**1.8**	**1.8**
Agriculture, forestry and fishing	-1.5	-0.2
Mining and quarrying	4.7	0.1
Manufacturing	3.4	0.4
Production of electricity, gas and water	-4.3	-0.1
Construction	-10.1	-0.3
Retail and wholesale trade, repairs	1.3	0.1
Hotels and restaurants	-1.9	0.0
Transport, storage and communications	6.9	1.1
Financial intermediation	6.9	0.3
Real estate activities, rentals	2.5	0.3
Other services	-0.5	-0.1
Activities – total	1.9	1.7
FISIM	5.7	0.2
GVA, at base prices	1.8	1.5
Taxes minus product subsidies	1.7	0.3

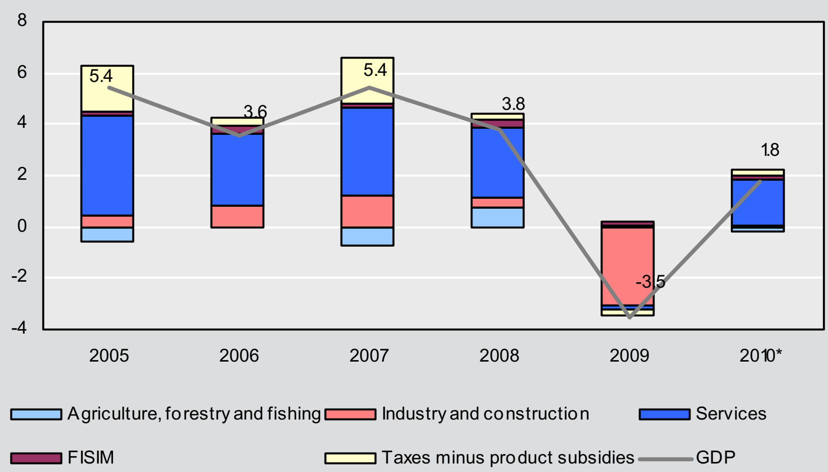
Source: Statistical Office and NBS.

as well as in sectors of wholesale and retail trade (due to recovery in retail trade in H2 2010).

In 2010, recovery was recorded in industrial production, chiefly manufacturing. The strongest positive contribution to industrial output came from the production of base metals, chemicals and chemical products, food, metal products and electrical appliances. Recovery was also registered in the mining sector, mainly in regard to the exploitation of crude oil and natural gas. The main headwind to industrial growth came from the sector of electricity, gas and steam supply, as a consequence of mild winter.

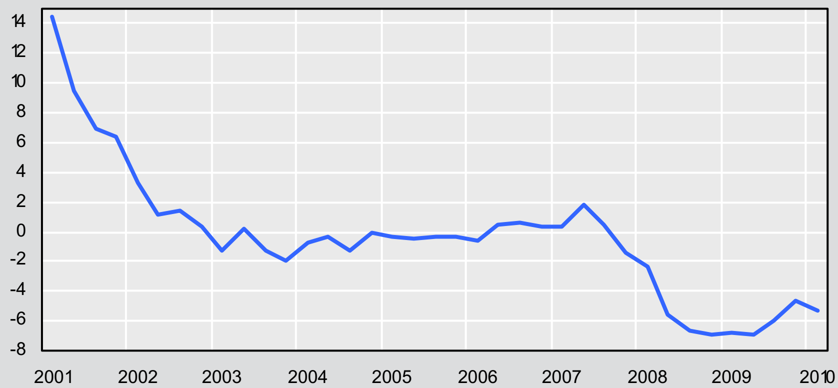
On the other hand, construction declined, though to a lesser extent than in 2009. Bad weather resulted in lower yields, i.e. a decline in agricultural output.

Chart III.6.1. Contribution to GDP growth – production side
(in percentage points)



Source: Statistical Office and NBS.
* Based on quarterly GDP data.

Chart III.6.2. Output gap
(percentage deviation from trend)



Source: NBS.

Reflecting economic recovery in 2010, the negative output gap moderated. It however remained pronounced, which signals a further disinflationary impact of aggregate demand.

7. Wages and employment

Total wages rose by 0.7% in real terms in response to real wage growth of 6.1% in the private sector. Public sector wages were cut 3.8% in real terms, in response to Government's decision to continue operating wage freezes in 2010.

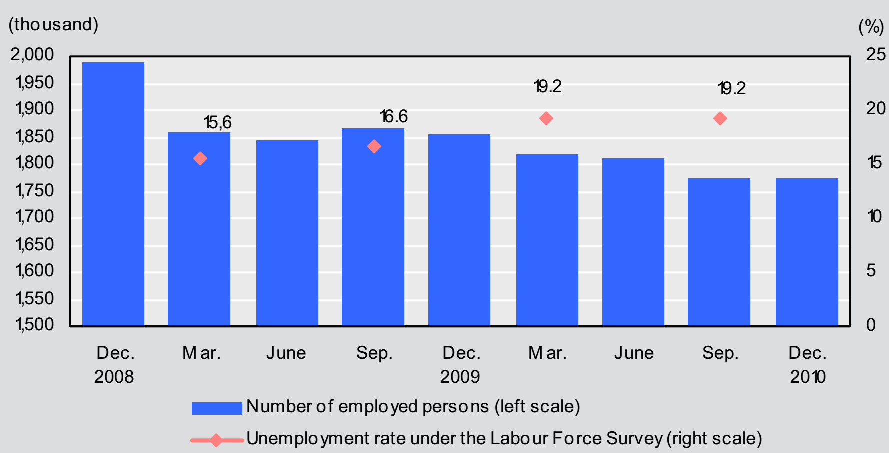
Slower growth in productivity relative to real gross wages resulted in an increase in unit labour costs of 2.7%.

Real wage growth was recorded in mining, manufacturing, wholesale and retail trade, transport and storage, financial intermediation and insurance, construction, and professional, scientific, innovational and technical activities. Other sectors recorded a decline.

Nominal wages rose by 7.6% (12.3% in the private and 2.4% in the public sector). The average net wage was RSD 34,142 (around EUR 330).

According to National Employment Service data, unemployment fell by 852 persons in December 2010 y-o-y. Statistical Office data suggest a 86,538 decline in employment numbers (4.7%). Broken down by sector, contraction in employment was driven by falling employment numbers (1.6 pp) and a decline in the

Chart III.7.1. Employment and unemployment rate



Source: Statistical Office.

number of entrepreneurs and employees (3.1 pp) in manufacturing.

Judging by the Labour Force Survey, the unemployment rate rose from 16.6% in September 2009 to 19.2% in March, remaining there in September 2010 as well. The official employment rate fell from 40.8% in September 2009 to 37.9% in September 2010, while unofficial employment declined from 20.6% to 19.6%.

As indicated in the Survey, employment numbers fell by 8.0%, while unemployment rose by 9.5% in September 2010 y-o-y. The number of over one-year job seekers rose by 6.1 pp (from 65.5% to 71.6%). Worsening in labour market conditions could not be halted in 2010 due to weak economic recovery.

8. Inflation expectations

One-year ahead inflation expectations rose in all sectors covered by the inflation expectations survey[18] – expectations for end-2011 trended above the upper bound of the target tolerance band.

In H1 2010, one-year ahead inflation expectations moved within the target tolerance band. They however increased in H2 and moved above the band.

According to surveys of research agencies *(Bloomberg, Thomson Reuters, Medium Gallup)*, financial sector inflation expectations declined at end-Q1 relative to end-2009, only to stabilise at around 6.0% in Q2. By contrast, corporates, households and trade unions recorded a moderate rise in inflation expectations in H1.

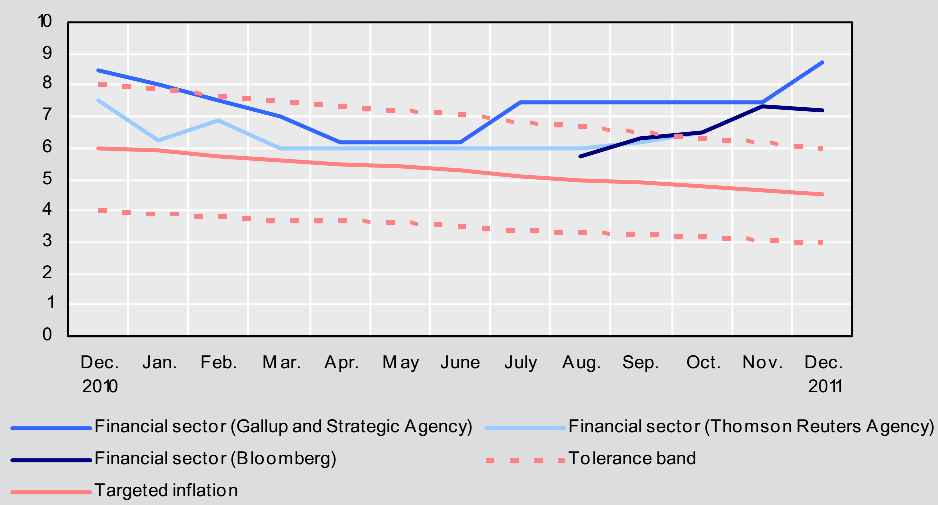
Inflation expectations of all sectors were on a moderate rise in H2 despite strong consumer price growth. Though above the target, inflation expectations did not rise to any significant extent, reflecting economic actors' assumption of temporary nature of the inflation pick-up, in view of its causes and restrictive monetary policy measures.

9. Fiscal policy

Consolidated budget deficit amounted to RSD 136.7 bln or 4.6% of GDP. Revenue totalled RSD 1,222.9 bln, while expenditure (following the budget revision) came at RSD 1,359.7 bln at end-2010. The deficit was financed mainly via domestic borrowing, which resulted in limited fiscal expansiveness, i.e. much weaker fiscal effect on demand (RSD 47.9 bln or 1.6% of GDP).

In 2010, the government continued to issue T-bills with the aim of budget deficit financing – up to 12-m maturities were extended to 24 months, hence providing a

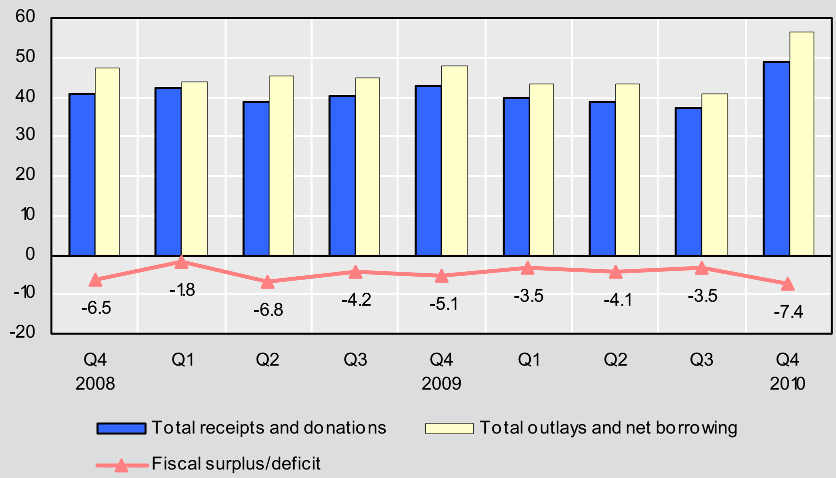
Chart III.8.1. One-year ahead expected and targeted inflation
(%)



Source: NBS.

[18] The survey covers the financial sector, enterprises, households and trade unions.

Chart III.9.1. Public revenue and expenditure*
(% of GDP)



* IMF Methodology.

Source: Calculated based on Ministry of Finance data.

boost to financial market development. The market value of total bills issued amounted to RSD 254.8 bln and the stock of debt reached RSD 164.6 bln.

The stock of total public debt rose to EUR 12.2 bln or 42.2% of GDP at end-2010, up by as much as 8.1 pp on end-2009. Owing to the T-bills issue, the public debt structure changed in a desirable direction – towards a greater share of the domestic currency and fixed interest rates. Reflecting an improvement in the currency structure, the dinar portion of debt reached 14.6% at end-2010 (vs. 12.8% by end-2009). Though still ranking among medium indebted countries, the speed of Serbia's borrowing was worryingly high in 2010.

The Budget System Law of 2010 introduced strict fiscal rules capping public debt to 45% of GDP (excluding debt under the restitution costs) and annual fiscal deficit to 1% of GDP over the medium term. However, the Law allows for short-term deviations enabling the pursuance of anticyclical fiscal policy[19]. This should contribute to the stabilisation of public debt.

In terms of fiscal revenue, 2010 was relatively successful given the gradual economic recovery following the exit from the economic crisis. Relative to 2009, total revenue rose by 3.8% in real terms. VAT receipts as the most important revenue category recorded modest real growth (1.5%), while sharper real growth was noted with excise receipts (6.5%) and non-tax revenue (23.6%).

Expenditure fell short of the 2010 target (though savings were made only in regard to capital expenditure). Remaining frozen, wages and pensions dropped by 3.6% in real terms, while capital expenditure picked up by 1.5%.

[19] Fiscal deficit may overshoot the target in the years of recession. It may however be smaller or turn into a surplus in the period of expansion.

IV. Monetary policy in 2011

Aiming to stabilise inflation around the target in the medium run, the NBS Executive Board tightened further its monetary grip in early 2011 by raising the key policy rate and amending the required reserves decision to halt further relaxation of required reserves. Lowering of inflation and its return within the target tolerance band in H1 2012 will be largely prompted by weakened cost push pressures on food prices in the event of a good agricultural season, low aggregate demand and monetary policy measures. Declining risk premium, improved credit rating and rising foreign investor participation in the domestic financial market resulted in appreciation pressures, which is likely to contribute to lowering of inflation. Similar trends were recorded in other Eastern European economies running flexible exchange rates. The full effect of monetary policy measures on inflation is yet to be felt. The NBS will continue using all available instruments to bring inflation back to the target in the medium term.

In cooperation with the Government, the NBS initiated the establishment and implementation of systemic measures and activities aimed at food market stabilisation. This would help avoid sudden shifts in the monetary policy stance prompted by vigorous volatility of inflation and inflation expectations, and in turn reinforce macroeconomic stability and bolster economic growth and employment.

The NBS will implement its monetary policy in 2011 pursuant to the Programme adopted by the Executive Board by end-2010.[20]

The primary monetary policy objective is to achieve the inflation target, whereby the NBS will contribute to the stability of the financial system and sustainable economic growth.

In 2011, monetary policy of the NBS will be based on the *Memorandum of the National Bank of Serbia on Monetary Strategy*[21] and the *Memorandum of the National Bank of Serbia on Setting Inflation Targets for the Period 2010–2012.*[22]

Expressed numerically – in terms of the annual percentage change in the consumer price index, the monetary policy objective for 2011 is to gradually lower the beginning-of-year inflation of 6%±2 percentage points to 4.5%±1.5 percentage points by the year-end. The inflation target is defined as a continuously declining value (with a tolerance band) of annual changes in consumer prices. It is set for each month of the year, meaning that the achievement of the inflation target is watched continuously, which contributes to the accountability and credibility of monetary authorities and helps anchor inflation expectations.

Monetary policy decisions of the Executive Board in the course of 2011 will be designed to facilitate the achievement of its medium-term inflation target. The objective is to gradually lower the beginning of 2012 inflation of 4.5%±1.5 percentage points down to 4.0%±1.5 percentage points by the end of 2012. The inflation target path set for the period until 2012 is consistent with the achievement of medium-term price

[20] *Decision on the Monetary Policy Programme of the National Bank of Serbia in 2011,* RS Official Gazette, No 95/2010.

[21] *The Memorandum of the National Bank of Serbia on Monetary Strategy* was adopted at the meeting of the Monetary Policy Committee of the National Bank of Serbia of 22 December 2008.

[22] *The Memorandum of the National Bank of Serbia on Setting Inflation Targets for the Period 2010–2012* was adopted at the meeting of the Monetary Policy Committee of the National Bank of Serbia of 14 December 2009.

stability and reflects the intention of the NBS to achieve price stability through gradual lowering of inflation without causing macroeconomic disturbances.

To pursue its inflation target, the NBS will use the interest rate on two-week repo operations as its main monetary policy instrument. This interest rate will be changed in a sustainable, consistent and predictable manner, in line with economic developments and inflation projections. In addition, the NBS will use all available instruments under its remit to achieve its medium-term inflation target.

Committed to transparent and accountable communication with the public, the NBS will a) issue press releases, b) hold press conferences, c) publish the Inflation Report, and d) issue other publications.

The NBS will continue to implement the managed floating exchange rate regime. The high level of FX reserves of the NBS will ensure the stability of the FX market. The NBS will intervene in the FX market to mitigate excessive daily volatility of the exchange rate and/or to encourage trading volumes, as well as to contain threats to financial and price stability.

In 2011, the NBS will continue to develop and strengthen market-based monetary instruments and to create conditions in cooperation with banks for the further upgrade of the interbank money market.

Given the still very high level of euroisation in Serbia, the NBS will continue to implement the dinarisation process in cooperation with the Government. Dinarisation will be based on three pillars: the preservation of macroeconomic stability, development of the dinar money and capital markets and development of hedging instruments. Reducing euroisation will contribute to monetary policy efficiency and reduced vulnerability of the public and private sectors to exchange rate volatility.

A stable and competitive financial system is the precondition for an effective transmission mechanism of monetary policy. The NBS will continue to take all necessary measures to ensure the existence of sound and stable financial institutions and maintain trust in the overall financial system, so as to enable efficient mobilisation of savings and allocation of investment. This will contribute to stronger resilience to external disturbances and risks inherent to financial operation.

The coordination between monetary and fiscal policies is important in an inflation targeting regime. In 2011, the NBS will continue to cooperate with the Government. The Agreement between the National Bank of Serbia and the Government of the Republic of Serbia on Inflation Targeting[23] commits the Government to pursue sustainable and predictable fiscal policy in line with the inflation target.

Should the actual inflation rate depart from its target for longer than six consecutive months, the NBS will notify the Government in writing about the reasons for such departure, propose policy action to be taken to deal with it and give an estimate of the period within which inflation can be expected to return within the target band.

[23] *The Agreement between the National Bank of Serbia and the Government of the Republic of Serbia on Inflation Targeting* was adopted at the Government's meeting of 19 December 2008.

Index of charts and tables

Charts

Tables

CIP - Каталогизација у публикацији
Народна библиотека Србије, Београд

336.71

ANNUAL Monetary Policy Report ... /
National Bank of Serbia. - 2010- . -
Beograd (Kralja Petra 12) : National Bank of
Serbia, 2011 (Beograd : Zavod za izradu
novčanica i kovanog novca Topčider) . - 30 cm

Godišnje. - Ima izdanje na drugom jeziku :
Годишњи извештај о монетарној политици =
ISSN 2217-6292
ISSN 2217-6535 = Annual Monetary Policy
Report
COBISS.SR-ID 185843468