ANNUAL MONETARY POLICY REPORT

National Bank of Serbia

2014

ANNUAL MONETARY POLICY REPORT

2014

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

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

www.nbs.rs
Number of copies: 60
ISSN 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 of the following year and the semi-annual by 30 September[1] of the year under review.

Pursuant to the Statute 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 2014* was adopted by the NBS Executive Board at its meeting of 11 June 2015.

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:

Jorgovanka Tabaković, Governor

Ana Gligorijević, Vice Governor

Veselin Pješčić, Vice Governor

Diana Dragutinović, Vice Governor

Đorđe Jevtić, Director of the Administration for Supervision of Financial Institutions

[1] Law on the National Bank of Serbia, RS Official Gazette, Nos 72/2003, 55/2004, 85/2005 – other law, 44/2010, 76/2012, 106/2012 and 14/2015.

[2] RS Official Gazette, Nos 12/2013 and 18/2015.

ABBREVIATIONS

bln – billion
bp – basis point
CEFTA – Central European Free Trade Agreement
CPI – Consumer Price Index
ECB – European Central Bank
EMBI – Emerging Markets Bond Index
FDI – foreign direct investment
Fed – Federal Reserve System
GDP – Gross Domestic Product
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
mln – million
NAVA – non-agricultural value added
Q – quarter
q-o-q – quarter-on-quarter
s-a – seasonally-adjusted
SDR – Special Drawing Rights
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Contents

Overview

Low inflationary pressures, which marked 2013, weakened still further in 2014. In addition to monetary policy measures and aggregate demand, low inflationary pressures were underpinned by the effects of temporary factors, such as the unusually small growth in administered prices, the fall in primary agricultural commodity prices and the collapse of global oil prices in the second half of the year. These factors exerted a decisive impact on inflation which moved below the lower bound of the target tolerance band (4±1.5%) for most of the year. From 3.7% in January, y-o-y inflation fell to 1.7% in December.

In an environment of subdued inflationary pressures, the NBS proceeded with monetary policy easing in 2014, though at a cautious pace. Caution in the conduct of monetary policy was warranted by the risks from the international environment and unfavourable fiscal movements at home, especially in the first half of the year. The key policy rate was cut in May and June by 50 bp each. The Executive Board decided to trim the key policy rate in view of the strong disinflationary effects of low aggregate demand and the weak cost-push pressure. The last downward revision of the key policy rate in 2014 took place in November. Namely, the Executive Board lowered it by 50 bp to 8%, guided by muted inflationary pressures, lower inflation projection and the adoption of additional fiscal consolidation measures aimed at reducing the domestic economy's exposure to risks from the international environment. Interest rates in the money and credit markets moved in step with the key policy rate.

International environment in 2014 was marked by persistently sluggish economic recovery of the majority of Serbia's key trade partners and by heightened uncertainties in the international financial market due to geopolitical tensions and divergent monetary policies of leading central banks. In the second half of the year, commodity markets were shaken by the collapse of oil prices, which exerted an additional downward effect on the already low inflationary pressures in the international environment.

In 2014, the domestic economic activity was severely affected by the negative effects of the May flooding. The greatest damage was inflicted on the sectors of energy and mining. Besides, activity in the manufacturing industry subsided, in response to the slower pace of growth of our key trade partners. In the last quarter of the year, however, economic activity recorded growth in s-a terms, owing to the gradual waning of the negative effects of the flooding and dampened external demand.

On the expenditure side, economic activity was most affected by the fall in household consumption and lower levels of private investment. Net exports are estimated to have provided a neutral contribution, given that the slowdown in the pace of exports caused by the flooding and lower external demand was counterbalanced by the weaker growth in imports induced by fiscal consolidation measures.

Though clouded by the negative effects of the flooding, positive trends in the current account of the balance of payments continued into 2014. The improvement in the current account was aided by the narrowing of the foreign trade and primary income account deficits, while the inflow from remittances underperformed relative to the previous year. Under the new methodology (BPM6), the current account deficit came at 6.0% of GDP, down by 0.1 pp from 2013. FDI roughly kept the level achieved a year earlier, portfolio investment contracted, while banks and enterprises net repaid their financial loans. The level of FX reserves was adequate despite a decrease relative to the end of 2013. At end-2014, FX reserves equalled EUR 9.9 bln or six months of imports of goods and services.

Consolidated fiscal deficit, which includes called guarantees and the recapitalisation of banks and state-owned enterprises, amounted to 6.7% of GDP, up by 1.2 pp from the year before. A significant portion of this deficit (3.0% of GDP) related to interest payments. Unlike in the first half of the year when budget revenue fell short of the initially planned, fiscal movements improved in the second half of the year, despite the effect of floods, primarily as a result of fiscal policy measures taken at the time to fight the grey economy and tax evasion, as well as the reduction of pensions and public sector wages. Owing to the Government's subsidised loan programme, lending activity increased in 2014, and so did the share of dinar loans in total corporate and household lending.

Like in most countries of the region, the foreign exchange market in Serbia was strained in early 2014 by the growing uncertainty in the international financial market caused by the winding down of the Fed's asset purchase programme. After the ECB decided in June to increase its monetary accommodation, investors' interest in emerging markets picked up, Serbia included, ushering in appreciation pressures. However, renewed turbulence in the international markets in the second half of the year weighed down on foreign capital inflow and our exports. The value of the dinar was additionally dented by domestic factors, including in particular increased FX demand of energy importers after the May flooding and uncertainty over the scope and pace of fiscal consolidation and structural reforms. During most of this period the demand for foreign exchange was also driven by banks' efforts to keep their assets and liabilities currency-matched. The pressures on the dinar weakened by the end of the year following the disbursement of several sizeable foreign currency-indexed loans and thanks to reduced dinar liquidity of banks and the adoption of additional fiscal consolidation measures.

Looking ahead, monetary authorities will continue to shape their policy towards achieving the inflation target (4±1.5%), i.e. stabilising inflation at low levels in the long run. The monetary policy stance will depend primarily on the effects of fiscal consolidation measures and structural reforms, but also on developments in the international environment and their impact on domestic economic and financial flows and local prices of primary agricultural commodities. Consistent implementation of fiscal consolidation measures, supported by the precautionary stand-by arrangement with the IMF and further narrowing of external imbalances will enable monetary policy to provide a greater contribution to the recovery of economic activity. Anchoring inflation expectations at the target level is an important prerequisite for keeping inflation stable. Significant progress was made in this respect, as both short- and medium-term inflation expectations of the financial and business sectors have been within the NBS target for more than a year now.

I. Monetary policy framework

The National Bank of Serbia (NBS) has been implementing a fully-fledged inflation targeting regime since early 2009, though elements of the strategy were gradually introduced into practice from 2006 onward. 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 appropriate monetary policy regime under the given circumstances.

The inflation targeting regime has so far been adopted by a number of central banks worldwide 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 the annual percentage change in the Consumer Price Index (CPI). To define the framework for medium-term monetary policy decision-making and to anchor inflation expectations, the NBS Executive Board adopted in October 2013 the inflation targets until end-2016.[4] Inflation targets are set as point targets with a tolerance band.

Based on macroeconomic projections, the NBS has set the inflation targets for all months until end-2016 at the level of 4.0% with a tolerance band of ±1.5 pp. The trajectory of inflation targets reflects the intention to achieve price stability without causing any disruptions to macroeconomic processes. Inflation targets remain above the quantitative definition of price stability and the level of inflation targets in advanced countries (2.0% or 2.5%). This reflects the fact that the structural reforms in Serbia will not be completed by 2016 and neither will the process of price liberalisation i.e. nominal, real and structural convergence to the EU.

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, the NBS will allow

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

[4] The National Bank of Serbia's Memorandum on Inflation Targets until End-2016, adopted by the Executive Board at its meeting of 18 October 2013.

inflation to temporarily diverge from the projected path if returning it to the target in the short term requires monetary policy changes that could cause additional disruptions to macroeconomic processes. This relates to shocks in primary commodity prices or deviations from the planned growth in prices under direct or indirect government regulation.

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

The NBS runs a managed float exchange rate regime which implies the right to intervene in case of excessive short-term volatility 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 the inflation target

1. Monetary policy in 2014

Monetary policy easing continued in 2014, though at a cautious pace. The key policy rate was cut by a total of 150 bp, to 8.0%.

Since the effect of monetary policy measures comes with a lag, the NBS Executive Board was guided by the projected rather than the current inflation in its decision-making on the level of the key policy rate. Therefore, **in the first four months of the year, the key policy rate was kept on hold at 9.5%**. Such decision was prompted mainly by the volatility in the international financial market, fuelled primarily by the geopolitical tensions over Ukraine and the Fed's decision to start tapering its QE programme after stimulating the US economy for six years. This heightened uncertainty across financial markets and elevated risk to capital flows towards emerging market economies, especially those running huge current account deficits.

As geopolitical tensions and the Fed's QE tapering did not exert a negative effect on Serbia's risk premium and foreign trade by the time of the Executive Board's **meeting in May** and the financial market responded well to the announced fiscal consolidation measures, **the key policy rate was trimmed to 9.0%**. A **further reduction to 8.5% took place in June**, in the wake of catastrophic floods that hit Serbia. The Executive Board was of the view that inflationary pressures would stay low in spite of the flooding. It was expected that in addition to weak aggregate demand, low inflationary pressures would be underpinned by the fall and steadying of both short- and medium-term inflation expectations and the relatively stable exchange rate. Besides, as the ECB increased its monetary accommodation, the Executive Board expected a pick-up in the international market liquidity and hence, subsiding of the risks stemming from abroad. The Executive Board acknowledged that the May flooding would take its toll on economic activity, especially in the sectors of energy, mining and agriculture. The balance of payments trends were less favourable than anticipated earlier, but the share of the current account deficit in GDP was lower than in the year before. A boost to the economy was expected from the new subsidised loan programme, works on the restoration of flood damage, and the gradual recovery of Serbia's main foreign trade partners. It was assumed that the Government would proceed with the implementation of fiscal consolidation and structural reforms and conclude an arrangement with the IMF.

Faced with mounting uncertainties in the international and domestic environment, the Executive Board **maintained** the key policy rate **at 8.5% all through to November**. There were concerns that persistent geopolitical tensions stemming from the crisis in Ukraine could dampen capital and energy flows, slow the pace of the euro area recovery, and send prices in the international commodity markets into an upward spiral. It was assessed that the protracted period of sluggish euro area recovery could have an adverse effect on domestic exports and economic activity because of our strong trade linkages with the euro area economies. Weaker external demand was assessed as leading to weaker export performance and a slightly higher than expected foreign trade deficit.

At the same time, uncertainty in the international capital market increased, fuelled by the Fed's QE tapering. The decision to wind down the asset purchase programme was made in October, while the first increase in the Fed's main rate was anticipated in H2 2015. At the same time, the ECB stepped up its monetary accommodation, but this seemed to have no effect on the liquidity of euro area banks.

The effect of external factors, along with uncertainties over fiscal movements at home, made the Executive Board halt the process of monetary policy easing. The level of the key policy rate was kept unchanged despite the strong disinflationary effect of low aggregate demand, which was likely to be reinforced still further by the new fiscal consolidation measures. The country's unfavourable fiscal position was additionally aggravated by the need to restore flood damage, which, along with the postponing of the adoption of fiscal consolidation measures for the end of the year, increased the size of the necessary fiscal adjustment.

Analyses of macroeconomic data during autumn months indicated that the economic activity was slowing down further because of the negative effects of the flooding, but also due to sluggish recovery of the euro area and Serbia's other foreign trade partners and additional fiscal consolidation measures.

At its **November meeting**, the Executive Board decided to **cut the key policy rate by 50 bp, to 8.0%.** Its decision was based on the fact that y-o-y inflation was moving below the lower bound of the target tolerance band from March 2014 and was likely to continue so in the period ahead under the extended disinflationary impact of the majority of relevant factors. It was highlighted that the implementation of fiscal consolidation measures and structural reforms would help ease the negative external effects stemming from uncertainties over divergent monetary policies of the Fed and the ECB. The expected signing of the agreement with the IMF was seen as an additional assurance of the credibility of Serbia's economic policy.

To support economic activity, the Executive Board **lowered the FX reserve requirement ratios in November and again in December** and changed the composition of allocations under FX reserve requirements by increasing the share in dinars. The reduction of FX reserve requirements lowered the cost of funding for banks and unlocked a part of their credit potential so as to bolster credit activity.

2. Monetary policy instruments

The main monetary policy instrument of the NBS is the key policy rate, i.e. the interest rate on the main 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. In addition to the key policy rate, the NBS uses other instruments of monetary regulation, notably reserve requirements and operations in the foreign exchange market.

Open market operations

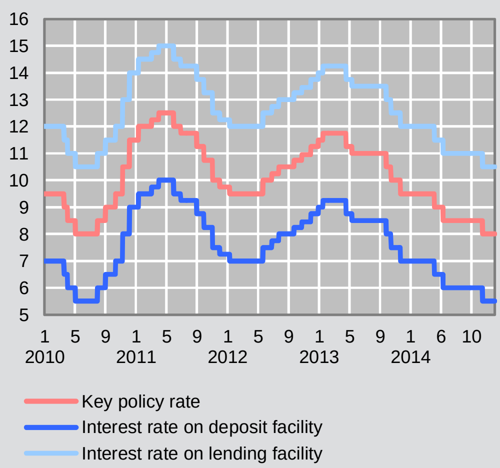
The main open market operations of the NBS in 2014 were one-week reverse repo transactions, i.e. repo sale of securities (liquidity-absorbing).

The NBS implemented reverse repo transactions by selling own securities. For these purposes, the NBS issued one series of bills in the nominal amount of RSD 500.0 bln. The issuing of one series of high nominal value is consistent with the practice in earlier years which enables a more adequate management of securities of the same series and facilitates liquidity management for banks.

There were 52 repo sale auctions in 2014. They were organised once a week and the securities were offered at the variable multiple interest rate. The sales totalled RSD 3,585.8 bln, less than in 2013 (RSD 4,247.2 bln).

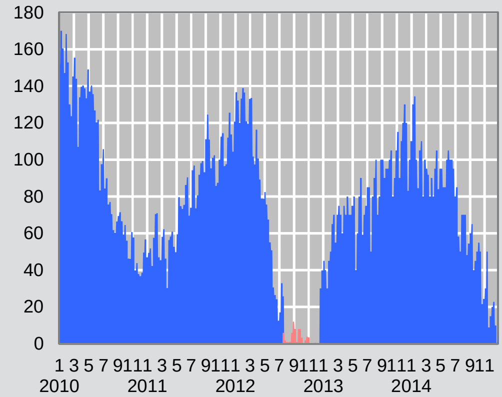
The stock of NBS bills in banks' portfolio averaged RSD 70.8 bln in 2014. Relative to end-2013, the stock of these bills decreased by RSD 102.5 bln, to RSD 7.5 bln.

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



Source: NBS.

Chart II.2.2 **Stock of sold/bought NBS securities**
(RSD bln)



Source: NBS.

By contrast to movements in 2013, the volume of sales contracted steadily in the course of 2014, and particularly in H2. The sales equalled RSD 2,424.5 bln in H1 and RSD 1,161.3 bln in H2. The drop in sales reflects a reduction in banks' excess liquidity driven mainly by NBS interventions in the IFEM.

Deposit and lending facilities

In accordance with the Decision on Terms and Conditions of Depositing Excess Liquidity with the National Bank of Serbia, banks continued to place their excess liquidity in overnight accounts with the central bank. No amendments to this Decision were adopted in 2014.

In 2014, the average daily balance of bank deposits in accounts with the NBS was RSD 15.2 bln, which is RSD 19.5 bln less than in 2013 (RSD 34.7 bln). The highest average monthly balance was recorded in January (RSD 27.6 bln) and the lowest in December (RSD 6.6 bln).

The Decision on the Conditions and Manner of Extending Daily Liquidity Loans to Banks against Collateral of Securities, which regulates NBS lending facilities, was not amended in 2014 either.

Lending facilities include intraday and overnight loans. During the period under review, banks used intraday loans in the total amount of RSD 74.7 bln, of which RSD 46.5 bln in Q4. Overnight loans in the total amount of RSD 27.6 bln were taken by four banks in late December.

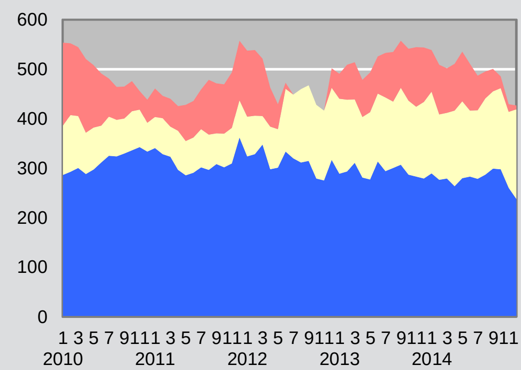
Reserve requirements

In 2014, the NBS continued to implement the Decision on Banks' Required Reserves, adopted in January 2011. The said Decision was amended twice – first in November and again in December.

At its November meeting, the NBS Executive Board lowered the FX reserve requirement ratios from 29% to 28% for liabilities with maturity up to two years and from 22% to 21% for liabilities with maturity over two years. At the same time, it raised the dinar share of FX required reserve allocations from 32% and 24% to 34% and 26% depending on the maturity of liabilities. The aim of this measure was to encourage bank lending activity in an environment of low inflation by lowering the cost of funding for banks and unlocking a part of their credit potential. Consistent with this and in order to reinforce the effects of the cut in the FX reserve requirement ratios, an obligation was introduced for banks to pay interest to the NBS on the amount of positive difference between the actual average daily balance of allocated and calculated FX required reserves during the maintenance period.

To provide an additional impetus to bank lending, the NBS Executive Board lowered the FX reserve requirement ratios by another 1 pp in December (to 27%

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



Source: NBS.

and 20% depending on the maturity of liabilities), increasing at the same time the dinar share of FX required reserve allocations by 2 pp (to 36% and 28% depending on the maturity of liabilities). This move was consistent with the NBS determination to encourage banks to increase their reliance on dinar and long-term sources of funding.

Required reserves allocated in dinars rose in 2014 by RSD 13.1 bln (to RSD 158.1 bln), mainly as a result of the regulatory increase in the dinar share of allocations under FX reserve requirements and the depreciation of the dinar. The rise in dinar required reserves was also spurred by the upturn in household dinar savings and corporate dinar deposits with banks. Required reserves allocated in foreign currency decreased in the course of 2014 by EUR 364.8 mln (to EUR 2.0 bln), reflecting cuts in FX reserve requirement ratios, bank deleveraging and the reduction in banks' FX liabilities to legal entities.

Foreign exchange market operations

In accordance with the Monetary Policy Programme for 2014, the NBS implemented a managed float exchange rate regime, intervening in the foreign exchange market to ease excessive short-term volatility of the exchange rate and to maintain price and financial stability and an adequate level of FX reserves.

In the year as a whole, the dinar depreciated against the euro by 5.2% in nominal terms. The NBS intervened in the IFEM by selling EUR 1,620 mln net, i.e. selling EUR 1,880.0 mln and buying EUR 260.0 mln. The NBS intervened strictly under market conditions, as the price taker.

Depreciation pressures that swept across the market until mid-March can be put down to the seasonally higher FX demand of domestic enterprises, notably energy importers, as well as to volatility in the international financial markets driven by the Fed's QE tapering. In late March, the country risk premium edged down and the dinar picked up. The NBS responded by buying foreign exchange. Overall in Q1, the NBS intervened by selling EUR 820.0 mln and buying EUR 20.0 mln. At the end of that quarter, the dinar was 0.6% weaker vis-à-vis the euro in nominal terms than at the end of 2013.

Q2 saw a surge in euro area liquidity, triggered by the ECB's increased monetary accommodation, as well as a drop in the country risk premium and a rise in non-residents' supply of foreign exchange. The NBS intervened in the IFEM in Q2 by buying EUR 170.0 mln. By the end of June, however, discouraging news on Serbia's macroeconomic and fiscal prospects caused a moderate increase in non-residents' demand for foreign exchange and ushered in depreciation pressures. At end-Q2, the dinar was 0.3% weaker in nominal terms than at end-Q1.

Depreciation pressures intensified in H2 under the impact of both global and domestic factors. Geopolitical events and volatile expectations regarding the Fed's future monetary policy stance and the economic recovery of the euro area increased uncertainty in the international financial market. Also, as the budget revision and adoption of additional fiscal consolidation measures were postponed because of the May flooding and there was growing demand for foreign exchange amid, in particular, increased payments of energy imports, exchange rate movements in this period were somewhat more pronounced. The reduction in the stock of foreign currency-indexed loans reinforced depreciation pressures, as banks tried to balance their FX risk ratios by buying foreign exchange[5]. Finally, at the close of the year, the downward pressures on the dinar gathered further pace as a result of FX purchases for dividend payment by successful domestic enterprises in majority foreign ownership. During this period, the dinar slumped against the euro by 4.3%. To ease excessive short-term volatility of the exchange rate, the NBS intervened in the IFEM by selling EUR 1,060.0 mln and buying EUR 70.0 mln.

Foreign exchange swaps

In 2014, the NBS continued holding regular three-month and two-week foreign exchange swap auctions to promote interbank swap trading and facilitate bank liquidity management. Three-month auctions were organised on a weekly basis and under market conditions. The amount of liquidity offered was limited. Two-week auctions, as an additional support to bank liquidity management, were also organised on a weekly basis, under market conditions and without a pre-determined amount of foreign exchange to be sold/bought.

[5] A decrease in foreign currency-indexed assets of a bank leads to a decrease in its FX position in the currency of indexation. To balance its FX position, i.e. FX risk ratio, the bank then buys the shortfall amount of foreign exchange in the foreign exchange market, which may give rise to depreciation pressures.

Overall in 2014, the NBS held 100 three-month and 100 two-week swap auction sales and purchases where it sold/bought EUR 55.0 mln and EUR 125.0 mln, respectively. At end-2014, NBS receivables and liabilities under three-month swaps equalled EUR 24.0 mln each, while those under two-week swaps were nil.

Short-term auction loans

To help banks maintain their liquidity, the NBS organised monthly auctions of short-term dinar loans against collateral of securities until May. Lacking demand in the market, the NBS decided to stop organising them as of June.

Other interest rates

In 2014, the NBS continued to implement the Decision on Interest Rates Applied by the National Bank of Serbia in the Implementation of Monetary Policy and the Decision on the Manner of Calculation, Collection and Payment of Interest by the National Bank of Serbia, adopted back in 2011.

These decisions were supplemented in November 2014, by the provision prescribing the interest rate (three-month EURIBOR applicable on the date on interest calculation plus 5 pp) which the NBS charges on the amount by which allocated required reserves exceed the average daily balance of calculated FX required reserves during the maintenance period.

3. Achievement of inflation target in 2014

Inflationary pressures, low throughout 2013, weakened further in 2014. At 0.1% in 2014, the average monthly rate of inflation was two times lower than in the year earlier. Low inflationary pressures stemmed not only from monetary policy measures and aggregate demand, but also from factors with temporary effect – an unusually low increase in administered prices, falling prices of primary agricultural commodities and tumbling global oil prices in H2 2014. As a result, y-o-y inflation moved below the lower bound of the target tolerance band during most of the year (4±1.5%).

In y-o-y terms, **inflation declined from 3.7% in January to 1.7% in December 2014**. The fall in y-o-y inflation was particularly strong in H1, while in H2 inflation hovered around 2%. After temporarily returning within the target tolerance band in January following an increase in the special VAT rate and regular annual adjustment of the excise tax, in March inflation slipped below the lower bound of the target tolerance band, where it remained until the end of the year. In June, y-o-y inflation fell to its 50-year low of 1.3%.

In 2014, only energy prices gave a negative contribution to inflation. The contribution of other components was positive, the largest coming from prices of services and unprocessed food.

Prices of services increased by 3.9% y-o-y in 2014 (0.8 pp contribution), primarily on the back of higher prices of travel arrangements and financial services.

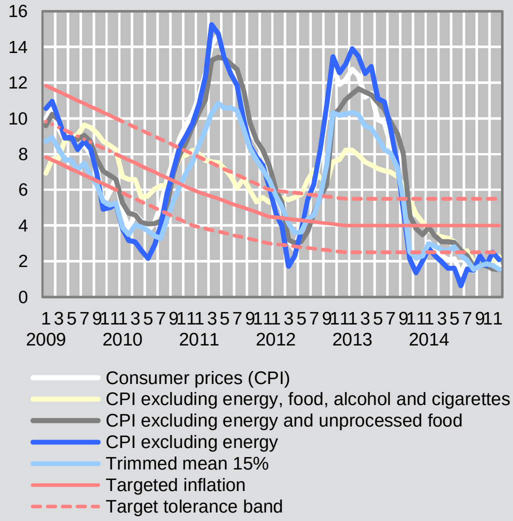
Food prices gained 2.2% in 2014 (0.8 pp contribution). After declining in H1, **unprocessed food prices** recorded stronger growth in H2, reaching 5.4% y-o-y in December (0.7 pp contribution). This was mostly due to fruit and vegetable prices which increased by 10.0% y-o-y late in the year, due to the low base effect from the prior year, contributing 0.8 pp to inflation. By contrast, **processed**

Table II.3.1 **Growth and contribution of components to consumer price growth in 2014**

	Growth rates (in %)	Contribution (in pp)
Consumer prices (CPI)	1.7	1.7
Unprocessed food	5.4	0.7
Processed food	0.5	0.1
Industrial products excluding food and energy	0.6	0.2
Energy	-0.3	0.0
Services	3.9	0.8
Core inflation indicators		
CPI excluding energy	2.1	18
CPI excluding energy and unprocessed food	15	11
CPI excluding energy, food, alcohol and cigarettes	2.3	10
Administered prices	11	0.2

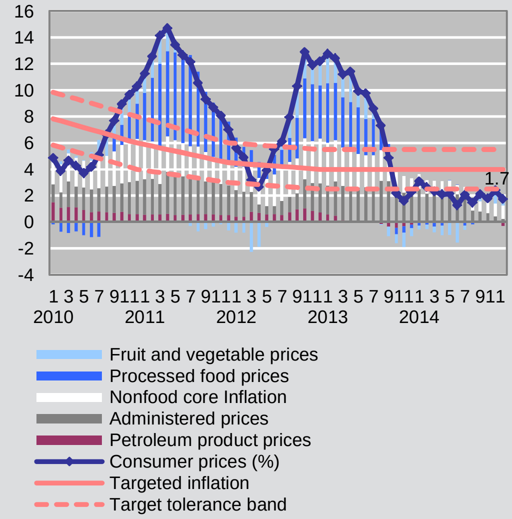
Source: SORS and NBS calculation.

Chart II.3.1 **Price movements**
(y-o-y rates, %)



Source: SORS and NBS calculation.

Chart II.3.2 **Contribution to y-o-y consumer price growth**
(pp)



Source: SORS and NBS calculation.

food prices were on a mild y-o-y decline almost until the end of the year. This was due to low prices of raw materials, reflecting a sharp fall in prices of primary agricultural commodities (mostly wheat and corn) in global and domestic markets from mid-May until October.

In H2 2014, slower growth in **energy prices** neutralised to a degree the positive contribution from rising prices of unprocessed food. Namely, with the exit of August 2013 electricity price increase from the calculation of y-o-y inflation, y-o-y growth in energy prices slackened from around 5%, its average in the first seven months of the year, to around 1% on average in the remaining five months of the year. Moreover, energy prices posted a y-o-y decline (by 0.3%) in December, for the first time since records are available. Energy price growth was slowed not only by an absence of electricity price increases in 2014 (and the resultant absence of an around 0.8 pp contribution to inflation, assuming the announced 15% increase), but also by a sharp downturn in global oil prices from the middle of the year and a corresponding fall in the prices of domestic petroleum products. The fall in petroleum product prices, however, was less pronounced than the decline in global crude oil prices due to a weakening of the dinar against the US dollar, and came at 6.2% y-o-y in December (-0.3 pp contribution).

Growth in **prices of industrial products excluding food and energy** slowed further in 2014, from 7.1% in January to only 0.6% in December (0.2 pp contribution). This was mostly led by prices of cigarettes, which declined by 8.0% towards the end of the year against a background of increased competition among producers driven by slumping trade in the tobacco products market. Their y-o-y growth slowed down from 26.7% in January to 0.8% in December, and their contribution to y-o-y inflation contracted from 1.2 pp to 0.0 pp.

In 2014, **administered prices**, i.e. prices under government control, increased least since records are available – by 1.1% y-o-y (0.2 pp contribution). In earlier years, they grew by 10% on average, to enable gradual correction of price disparities. Such low growth in 2014 resulted primarily from the fact that electricity prices remained unchanged, while cigarette prices declined late in the year.

Core inflation[6], as part of the CPI most strongly influenced by monetary policy, came to 2.3% y-o-y in December (1.0 pp contribution to y-o-y inflation). Core inflation declined during 2014, moving below the lower bound of the target tolerance band from August onwards. Such movements in core inflation reflected low aggregate demand, low inflation in the international environment and relative stability of the dinar exchange rate.

[6] CPI excluding prices of energy, food, alcohol and cigarettes, as the most frequently used measure of core inflation.

As y-o-y inflation moved below the lower bound of the target tolerance band for six consecutive months (4.0 ± 1.5%), **in September the NBS sent a letter to the Government** explaining the reasons for such departure. Inflationary pressures weakened as a result of several factors, including in particular low aggregate demand, relatively stable movements in the foreign exchange market and reduced cost-push pressure on food prices. And while the disinflationary effect of the first two factors was as expected, the drop in food production costs was sharper than anticipated. The absence of adjustment of electricity prices in the last year also played a role in inflation target undershooting. When it comes to monetary policy measures, the NBS emphasised that the lowering of the key policy rate continued in 2014. However, due to the strong impact of geopolitical tensions on country risk premium and the exchange rate, the NBS had to be cautious in the conduct of its monetary policy, in order to stabilise inflation at low levels in the longer run.

III. Macroeconomic environment

1. International environment

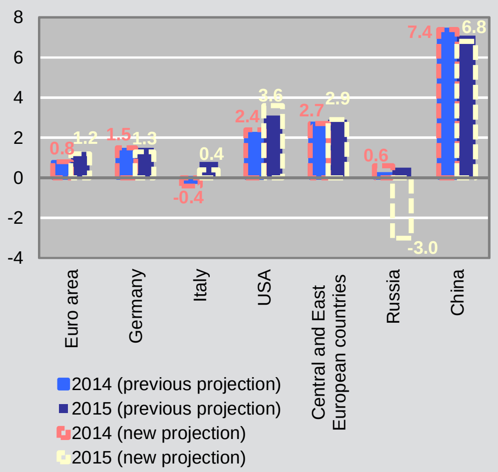
In 2014, the international environment was strongly affected by uncertainties over the effects of the normalisation of the Fed's monetary policy, heightened geopolitical tensions, primarily stemming from the Ukraine crisis, and the significant drop in the prices of primary commodities from the middle of the year. The global economy continued its modest and uneven growth. Recovery from the global financial crisis was slow and post-crisis adjustment process is still not completed.

Although the Ukraine crisis negatively reflected on market participant activity and confidence, **the euro area economy** expanded by 0.9% in 2014, which is the second climb out of recession since the global financial crisis began. Economic activity grew on account of the recovery of domestic demand. The situation in the labour market also improved somewhat, which is confirmed by the fall in unemployment from 11.8% in early 2014 to 11.4% in December. The growth in the euro area was led by the largest European economy – Germany (1.6%), and the rise in GDP, though uneven, was recorded by all members of the euro area except for Italy, Cyprus and Finland. Italy, one of our key foreign trade partners, recorded a fall in GDP (0.4%) for the third year in a row. On the other hand, Greek economy recovered slightly (0.8%) in 2014, following six years of recession.

Euro area economy is recovering with difficulty, after a long period of extremely low inflation. Y-o-y inflation, which has been below the 2% target since 2013, continued down in 2014, reaching the negative zone (-0.2%) in December, for the first time since 2009. The December deflation was mostly caused by a sharp fall in oil prices in the world market, which is also why the euro area situation is still not classified as an outright deflation, i.e. a general, long-lasting and self-perpetuating fall in prices.

Unlike the euro area, **the US economy** seems to be on a trajectory of sustainable growth. Its growth accelerated in 2014 to 2.4% owing to increased household consumption, investments and exports. The situation in the labour market continued improving, which is signalled by a fall in unemployment from 6.6% to 5.6% during the year, and a rise in the average monthly non-farm payroll

Chart III.1.1 **Revisions of real GDP growth forecasts for 2014 and 2015 by the IMF**
(%)

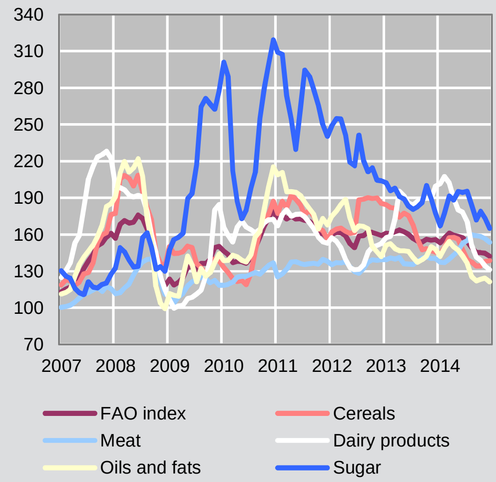


Source: IMF WEO (October 2014) and IMF WEO Update (January 2015).

employment (by 30% relative to 2013). Y-o-y inflation moved below its long-term target of 2% for most of the year. It recorded a more prominent fall in December due to energy prices (to 0.8%), which is the second lowest end-year inflation in the US in the last 50 years.

Other than in terms of economic performance, the differences between the US and the euro area expanded last year in the area of **monetary policy** as well. While the Fed started tightening its monetary policy, the ECB further eased its own. The Fed's decision to start tapering its QE programme from the start of the year was prompted by the improving situation in its labour market and the assessment that the US economic growth is sustainable. In early 2014, this decision affected movements in financial markets to an extent, causing capital outflows and depreciation pressures on currencies of developing economies such as Serbia. The programme was finally ended in October, and it is expected that the Fed may start increasing its policy rate as early as in 2015.

Chart III.1.2 **World food price index**
(2002 - 2004 = 100)



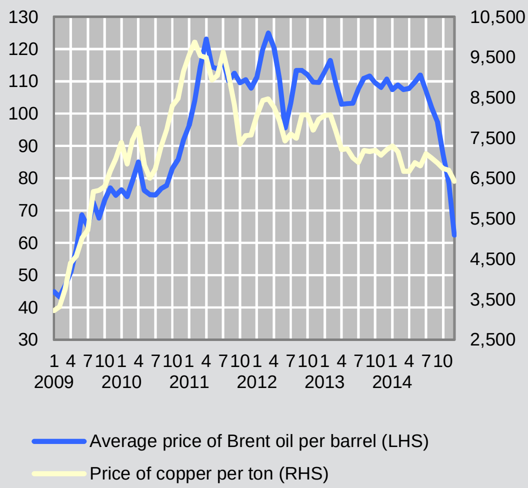
Source: FAO, UN.

Faced with deflation risk and a slackening increase in economic activity, in addition to further cutting its policy rate, the ECB undertook some unconventional monetary policy measures in 2014. After twice lowering its policy rate to a historic minimum (0.15% in June and 0.05% in September), along with introducing a negative rate on deposit facilities, the ECB implemented the first targeted long-term refinancing operations in September, and started purchasing securities from the private sector in Q4 (asset backed securities and covered bonds). The programme of purchasing private securities (expanded in January 2015 to include government securities purchases) is set to last for at least two years and is aimed at encouraging lending. This will help compensate for reduced liquidity in the international financial market after the completion of the Fed's QE programme, and could lead to greater capital inflows to developing economies.

According to preliminary estimates, growth in economic activity in Central and East Europe was similar to the 2013 level, amounting to 2.7%. It remains uneven despite the rise in domestic demand in most countries in the region. In Hungary and Poland economic growth accelerated (to 2.8% and 3.2%, respectively), while in Southeast Europe it mostly decelerated, partly due to extensive floods which hit primarily Serbia, Bosnia and Herzegovina and Croatia. Inflation fell in most countries because of lower food and energy prices and disinflationary pressures from the euro area, especially economies whose rate is firmly fixed to that of the euro. Therefore, central banks in the region continued easing their monetary policies in 2014 by cutting their policy rates. The exceptions were the Turkish and the Russian central bank. The central bank of Turkey increased its policy rate by as much as 550 bp (to 10.0%) in January, stating growing risk premium and strong depreciation pressures as the reason (due to the Fed's QE tapering, political crisis in the country and widening external imbalance), but reduced it by a total of 175 bp by year-end. Faced with depreciation pressures and rising inflation following the outbreak of the Ukraine crisis, the Russian central bank increased its policy rate six times in 2014 (by a total of 11.5 pp), with the highest increase in December (from 10.5% to 17.0%).

Foreign exchange markets were affected by the marked strengthening of the US dollar from the middle of the year, driven by the expectation that the Fed's monetary policy will increasingly differ from the monetary policies of other leading central banks, primarily the ECB and the Bank of Japan. After a period of relative stability in H1, when the rate moved between 1.35 and 1.40 dollars per euro, the dollar strengthened

Chart III.1.3 **Oil and copper price movements**
(average monthly prices, USD)



Source: Bloomberg.

by around 15% against the euro from May until December, and at end-2014 the rate was 1.21 dollars vis-à-vis the euro. End-of-period, the dollar appreciated by 13.6% against the euro in 2014.

Measured by the FAO Index, **global food prices** declined by 8.7% in 2014. Milk and dairy prices lost the most (34.3%) due to an increased supply and imposition of sanctions on Russia to milk imports from the EU in H2. Prices of oil, sugar and wheat also fell, by 18.1%, 7.0% and 4.9%, respectively. The only component of the Index which recorded growth was the price of meat (9.6%), which reached a historic high in September, driven by an epidemic of a pig disease in the US in Q2 and lower supply arising therefrom, and by a diminished supply of cattle from Australia in Q3.

Brent oil price went down by 43.7% in 2014 (end-of-period), despite its stable movement in H1. However, in the second half of the year it plummeted chiefly on account of a significant boost in US oil production from oil shale, the strengthening of the dollar and the unwillingness of OPEC member countries to cut back on production. At end-December, the price of oil equalled USD 62 per barrel, nearly half its value from end-June (USD 112 per barrel), which was the lowest price since mid-2009.

After a considerable growth in Q1 (9.4%), **the price of gold** started falling in April on account of heightened uncertainty over the rate of recovery of the US economy after the country was hit by a wave of extremely cold weather and over tightening geopolitical tensions in Ukraine. Although the price of this precious metal was occasionally affected by the Ukraine situation, other factors had a dominant sway (estimates that the Fed could begin increasing its policy rate sooner, the agreement between the ECB and the central banks of Switzerland and Sweden to coordinate gold transactions, strengthening of the dollar, etc.), driving the price of gold down by around 10% by end-2014. For the year as a whole, the price of gold fell by 1.7%.

The price of copper declined by 10.8% in 2014 (end-of-period). With the exception of Q2, when it was on the rise because of increased demand from China, the leading world consumer of copper, in other quarters it recorded a fall. The main factors contributing to the fall were signals of a slowdown in the growth of the Chinese economy and the strengthening of the US dollar, as well as expectations that low energy prices would encourage higher copper output. In late 2014, the price of copper was at its lowest level since November 2009.

2. International transactions

Balance of payments and foreign exchange reserves

Positive movements in the current account of the balance of payments[7] continued in 2014, despite the strong impact of the May floods. The improvement in the current account was aided chiefly by the higher surplus on the services account and lower deficit on primary income and goods accounts. Unlike a year earlier, the capital and financial account posted a net capital outflow.

In contrast to 2013, when earlier investments in the automobile and oil industries reached their full effect on exports, developments in 2014 were largely aggravated by the floods and contraction in the domestic economic activity. Still, the current account of the balance of payments improved in 2014 as well – a deficit of EUR 2.0 bln was recorded, down by EUR 113.6 mln, or 5.4% from 2013. Its share in estimated GDP fell to 6.0%, by 0.1 pp relative to 2013.

[7] Balance of payments data under the BPM5 methodology were used in the Report.

The current account deficit also declined, due to the lower deficit of **trade in goods** achieved thanks to a faster growth in exports relative to imports. Total commodity exports reached EUR 10.6 bln, up by EUR 126.1 mln from the year before, while imports increased by EUR 78.0 mln to EUR 14.8 bln. Though a decline was recorded in terms of both export and import prices, export prices declined at a slower pace than import prices (3.8% and 5.9% y-o-y, respectively). As a result, the terms of trade improved by 2.2%.

The highest increase was recorded in food exports, primarily cereals, followed by a rise in exports of meat and meat products, fruit and vegetables and dairy products, owing to a better agricultural season and increased exports to Russia. Despite the underutilisation of capacities in the Smederevo steel plant, the volume of exports of iron and steel increased when compared to 2013, while exports of non-ferrous metals declined, partly due to a drop in their prices in the global market. Dampened activity in domestic chemical industry contributed to the weakening of both exports and imports of chemical products. Positive effects of earlier FDIs into manufacturing industry are reflected in the continued rise in exports of electrical machinery and equipment, tobacco, paper and board packaging, clothes, footwear and textile products.

At EUR 1.5 bln, motor vehicles remained the chief export product of Serbia in 2014. This is, however, down by approximately EUR 100 mln y-o-y, due to difficulties in selling these products in foreign markets amid tough international competition. Imports of automobile parts have also dipped, whereas weak domestic demand and limited purchasing power contributed negatively to lower imports of automobiles. Despite the decline in exports of the leading individual producer, Fiat, exports of companies manufacturing car components, whose production is almost exclusively aimed at foreign markets, keep increasing.

Trends in foreign trade in the energy sector were divergent. On the one hand, May floods practically halted electricity exports in H2, so 2014 saw exports falling by EUR 143 mln from the previous year. For the very same reason, electricity imports increased, as did the imports of coal for generation of electricity. On the other hand, exports of petroleum products increased y-o-y (around EUR 30 mln), while imports decreased notably (by around EUR 100 mln), owing to modernisation of the capacities in oil industry. The slackened activity in chemical and metal processing industries was the main contributor to lower imports of natural gas, but also of inputs for chemical industry. Still, given the significant share of energy in total imports (14.0%), and its much lower share in total exports (3.7%), the foreign trade balance of the energy sector was negative, measuring around EUR 1.8 bln.

Table III.2.1 **Serbia's balance of payments**[1)]
(EUR mln)

	2013	2014
I CURRENT ACCOUNT	-2,098.3	-1,984.7
1. Goods	-4,158.7	-4,110.7
1.1 Credit	10,515.0	10,641.0
1.2. Debit	14,673.7	14,751.7
2. Services	313.5	465.3
2.1 Credit	3,422.0	3,809.6
2.2. Debit	3,108.6	3,344.4
3.Goods and services	-3,845.3	-3,645.4
3.1 Credit	13,937.0	14,450.7
3.2. Debit	17,782.3	18,096.1
4. Primary income	-1,418.6	-1,342.6
4.1 Credit	606.8	642.3
4.2. Debit	2,025.5	1,984.9
of which: interest	917.3	907.6
5. Secondary income	3,165.6	3,003.3
5.1 Credit	3,537.5	3,399.8
5.2.Debit	371.9	396.6
III CAPITAL ACCOUNT	15.3	6.5
IV FINANCIAL ACCOUNT (excluding reserve assets)	-2,326.8	91.6
1. Direct investment, net	-1,298.1	-1,236.3
1.1 Net acquisition of financial assets	249.7	264.2
1.2. Net incurrence of liabilities	1,547.9	1,500.5
2. Portfolio investment, net	-1,882.7	-368.9
2.1 Net acquisition of financial assets	29.5	72.9
2.2. Net incurrence of liabilities	1,912.1	441.7
3. Financial derivates, net	-0.6	-6.0
3.1 Net acquisition of financial assets	-6.4	-5.8
3.2. Net incurrence of liabilities	-5.7	0.2
4. Other investment, net	854.7	1,702.8
4.1 Trade credit and advances, net	-203.8	116.4
4.1.1 Net acquisition of financial assets	587.3	436.5
4.1.2. Net incurrence of liabilities	791.1	320.1
4.2. Financial loans, net	1,285.9	756.7
4.2.1 Net acquisition of financial assets	-64.3	-33.5
4.2.1.1 Long-term	-37.6	-36.0
4.2.1.2. Short-term	-26.7	2.5
4.2.2. Net incurrence of liabilities	-1,350.2	-790.2
4.2.2.1 Long-term	-1,091.8	-687.8
4.2.2.2. Short-term	-258.4	-102.4
4.3.Currency and deposits, net	-227.5	829.7
4.3.1 Net acquisition of financial assets	-249.6	935.2
4.3.2. Net incurrence of liabilities	-22.1	105.5
4.4 Other	0.0	0.0
V Reserve assets	696.7	-1,796.7
VI NET ERRORS AND OMISSIONS	453.0	273.1
VII OVERALL BALANCE	-696.7	1,796.7

Source: SORS and NBS.
Note: Preliminary data.
[1)] BPM6 methodology.

As in the previous years, the EU remained our largest export market, where around 65% of total exports of goods were sold in 2014. On the other hand, the highest proportion of goods was imported from the EU (around 63% of total imports of goods). Apart from the EU, other significant foreign trade partners are CEFTA countries (accounting for around 19% of total exports and 5% of total imports of goods), with which Serbia has for years been recording a positive balance of trade in goods.

The surplus on the **services account** continued to provide a positive contribution to the current account balance in 2014. In fact, it rose on 2013 by 48.4%. This rise can be put down primarily to telecommunications, computer and information services, construction services and processing services. At the same time, transport and travel, as the key items of the exports and imports of services, posted a deficit, though smaller than in the previous year.

Improvement in the current account was also aided by a 5.4% smaller deficit on the **primary income account** resulting from somewhat higher revenues and lower expenses than a year earlier. The revenues rose to EUR 642.3 mln, primarily owing to FDIs, which accounted for the largest portion of the revenues on the primary income account (50.3%). On the other hand, expenses fell to EUR 2.0 bln, chiefly due to lower expenses for interest payment on other investments (by EUR 102.5 mln, to EUR 447.1 mln), but also from FDI income (by EUR 66.4 mln, to EUR 1.1 bln). Only expenses under income from portfolio investments went up by EUR 125.0 mln and amounted to EUR 379.2 mln.

The surplus on the **secondary income account** fell by EUR 162.3 mln from 2013 to EUR 3.0 bln, driven primarily by the fall in the net inflow of remittances by EUR 296.8 mln to EUR 1.9 bln. Although lower, the surplus on the secondary income account covered the deficit on the balance of goods and services and on the primary income account by 60.2%.

The capital and financial account (excluding changes in FX reserves) saw a net capital outflow of EUR 85.1 mln in 2014 compared to the net inflow of as much as EUR 2.3 bln last year (attributable primarily to government borrowing in the international financial market through sale of eurobonds and on account of FDI).

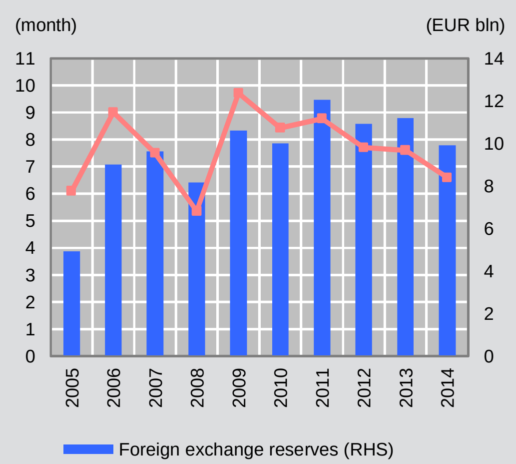
Net FDI was insignificantly lower than in 2013, down at EUR 1.2 bln. However, the structure of FDI was favourable, i.e. investment in equity capital rose by EUR 321.5 mln to EUR 951.2 mln, while reinvested earnings and intercompany borrowing were down by EUR 74.6 mln and EUR 308.7 mln, respectively. Most FDI in this period flowed into industry, trade and financial sector.

Portfolio investments generated a net inflow of EUR 368.9 mln, almost entirely on account of the sale of long-term government securities to non-residents in the domestic market. The inflow was significantly below the 2013 level, when the government issued eurobonds in the international market as well.

Financial credits were net repaid by EUR 756.7 mln, compared to EUR 1.3 bln in 2013. As in 2013, the majority of this amount was paid off by domestic commercial banks and the NBS (EUR 829.2 mln and 574.3 mln, respectively). Other financial institutions also net repaid their credits (EUR 29.8 mln). Net repayment of loans was also posted by enterprises, although in a considerably smaller amount (EUR 85.1 mln) than a year earlier (EUR 426.8 mln). By contrast, the government net borrowed EUR 728.1 mln, most of which came from the USD 1 bln loan from the Government of the United Arab Emirates, granted at a nominal interest rate of 2.0% and maturity of ten years.

The above movements in the current and financial account brought about a EUR 1.8 bln (EUR 1.3 bln in nominal terms) decrease in **NBS FX reserves** in 2014 (excluding currency changes, changes in the market value

Chart III.2.1 **Ratio of FX reserves to imports**



Source: SORS and NBS.
*12-month moving averages.

of securities and the price of gold). On 31 December 2014, NBS FX reserves stood at EUR 9,907.2 mln, covering money supply M1 by 278% and more than six months of imports of goods and services. At the same time, net FX reserves equalled EUR 7,657.0 mln, down by EUR 181.0 mln from end-2013.

At end-2014, foreign securities made up the largest portion of FX reserves – 66.7%, followed by FX balances in accounts abroad – 24.5%, gold – 5.6%, foreign cash – 2.7% and SDRs with the IMF – 0.5%. A part of FX reserves was invested in short-term securities and short-term deposits, in accordance with the liquidity principle, for the purposes of timely settlement of the NBS and government's external obligations.

The NBS recorded foreign exchange inflow from the sale of RS government securities in the domestic financial market in 2014 in the amount of EUR 1,079.5 mln. In addition, disbursement of credits for the Republic of Serbia provided for an inflow of EUR 1,013.5 mln, temporary payment transactions with Kosovo and Metohija[8] – EUR 365.8 mln, and donations – EUR 117.0 mln. The NBS also recorded FX inflow from investments in foreign securities and interest on FX deposits – EUR 51.1 mln.

In 2014, a total of EUR 1,475.0 mln[9] net flowed out of FX reserves on account of the central bank's interventions in the IFEM. Liabilities to foreign creditors were settled on time (EUR 891.9 mln). Banks withdrew FX required reserves in the net amount of EUR 724.7 mln. The payment of debt to the IMF (principal and interest) accounted for an outflow of EUR 572.7 mln, while the redemption of matured RS euro-denominated securities shook off EUR 423.1 mln from FX reserves. The servicing of old foreign currency savings dragged FX reserves down by EUR 282.1 mln, while reserves fell by EUR 91.1 mln on account of repayment of government debt to domestic banks.

International investment position

Serbia's international investment position of a net debtor nation increased in 2014 by EUR 2.1 bln as a consequence of a rise in net financial liabilities which significantly exceeded the increase in net financial assets. It reached EUR 32.9 bln, or 99.6% of estimated GDP at year-end. The increase was brought about by transactions (EUR 1.7 bln) and currency changes (EUR 579.4 mln), whereas price and other changes exerted a downward effect equivalent to EUR 173.2 mln.

Serbia's net external financial assets increased by EUR 457.5 mln to EUR 18.5 bln in 2014. The increase was caused by currency changes (EUR 384.4 mln), price and other changes (EUR 200.4 mln), while net transactions exerted a downward effect equivalent to EUR 127.3 mln.

The greatest changes in net financial assets were recorded on other investments, which rose by EUR 1.4 bln and FX reserves, which fell by EUR 1.3 bln. Of other investments, currency and deposits of residents abroad (banks) rose the most, by EUR 935.2 mln, to EUR 4.9 bln, their share in total assets climbing to 26.3%. In addition, trade credits and advances increased by EUR 436.5 mln in 2014. On the other hand, loans, which chiefly pertain to banks, went down by EUR 33.5 mln to EUR 71.1 mln.

Foreign direct investments by residents went up by EUR 264.2 mln, thus receivables on this account amounted to EUR 2.3 bln at end-2014, or 12.7% of total assets. Portfolio investments more than doubled, from EUR 56.0 mln to EUR 141.3 mln, although they still make up a small share of total assets (0.8%).

Net external financial liabilities rose by EUR 2.6 bln in 2014 to EUR 51.4 bln, as a result of higher net transactions (by EUR 1.6 bln) and positive currency and other changes (by EUR 991.1 mln). The increase in net transactions was mainly from FDI and portfolio investments.

Liabilities under FDI climbed by EUR 1.5 bln to EUR 24.4 bln (47.4% of total liabilities), primarily owing to investments in equity capital (EUR 1.4 bln). At end-2014, liabilities under equity investments came at EUR 18.3 bln (35.7% of total liabilities), and those under debt instruments at EUR 6.0 bln (11.7% of total liabilities).

Liabilities under portfolio investments went up by EUR 989.1 mln in 2014 (14.4% of total liabilities). The increase was entirely based on long-term government

[8] Under the Law on Temporary Execution of Certain Payment Operations in the Federal Republic of Yugoslavia (FRY Official Gazette, No 9/01).

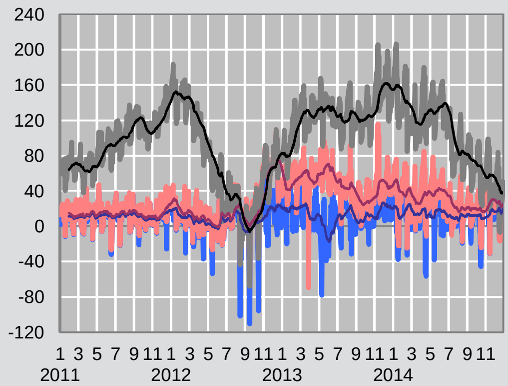
[9] In accordance with accounting rules, transactions in respect of NBS interventions in the IFEM are disclosed on the execution day and not on the trading day.

debt securities. More than half of the increase was on account of currency changes (EUR 547.4 mln), while net transactions amounted to EUR 441.7 mln.

In the structure of financial liabilities, liabilities of residents under other investments also went up (by EUR 79.2 mln, making up 38.2% of total liabilities). The increase was led by currency and other changes (EUR 443.9 mln), while net transactions exerted a downward effect (EUR 364.6 mln). Under transactions, a decline was recorded for financial credits (EUR 790.2 mln), and an increase for trade credits and advances (EUR 319.7 mln) and currency and deposits (EUR 105.5 mln). Positive currency changes related mostly to financial credits (EUR 391.5 mln).

The comparison of international investment positions at end-2014 and end-2013 shows that total gross external debt rose by EUR 711.6 mln to EUR 31.5 bln, or 95.1% of GDP. Only gross external debt of the government increased, by EUR 2.1 bln to EUR 16.2 bln, while that of other sectors was cut. Debts of the NBS decreased by EUR 546.2 mln to EUR 202.3 mln. Banks reduced their gross debt by EUR 709.1 mln to EUR 3.4 bln (10.9% of total gross external debt). The corporate sector also cut its gross debt by EUR 85.4 mln to EUR 11.7 bln at end-2014 (37.1% of total gross external debt).

Chart III.3.1 **Dinar liquidity**
(daily stock and moving averages, RSD bln)



Source: NBS.

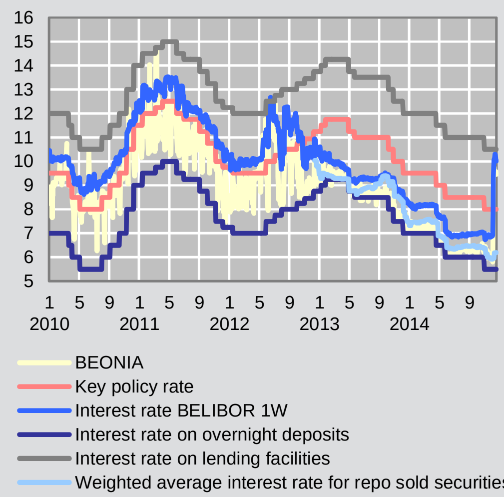
3. Financial market

Interest rates

Mirroring movements in the key policy rate, the average repo rate[10] reached 6.2% in late December, down by 1.4 pp compared to end-2013.

Trading volumes in the interbank overnight money market averaged RSD 2.5 bln in 2014, which is more than double the level recorded in 2013. The increase was particularly pronounced in Q4 because of reduced excess liquidity of banks. In the course of 2014, BEONIA followed the path of the average repo rate and was on a moderate decline up to late 2014. In the last two weeks of December, demand for dinars went up. As banks tapped credit rather than deposit facilities, BEONIA temporarily moved close to the upper bound of the NBS interest rate corridor. As a result, the average monthly BEONIA touched 7.4% in December, down by 0.2 pp y-o-y.

Chart III.3.2 **Interest rate movements**
(daily data, p.a., %)



Source: Thomson Reuters and NBS.

BELIBOR rates showed similar dynamics. Despite the December rise, they declined at the year-level. The decline was steeper for longer-maturity securities, leading to the narrowing of the yield curve slope in the interbank

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

money market. In the course of December, average BELIBOR rates ranged from 8.0% for the shortest to 8.8% for six-month maturity.

Rates in the primary market of dinar government securities also declined in 2014, notably during H1. The drop was sharper for rates on the shortest-maturity – three- and six-month securities, which fell by 2.1 pp and 1.9 pp to 7.0% and 7.1% by the year-end respectively. The decline was prompted not only by cuts in the key policy rate, but also by smaller volumes of these securities offered for sale.

Non-resident behaviour largely determined movements in rates on longer-maturity securities. Following the January drop, they went up in February and March due to weaker non-resident interest. Prompted by geopolitical tensions and the tapering of the Fed's QE programme, non-resident interest weakened only temporarily, but stepped up already from the second half of March. Interest rates fell further in May and June in light of a lower country risk premium and the ECB's decision on additional monetary policy accommodation. In H2, the rates on longer-maturity securities did not change much. Auction performance weakened, reflecting reduced need of the government to borrow against dinar securities because foreign sources of funding were available and the amount required for redemption of securities at year-end was significantly smaller compared to H1. In late 2014, due to increased aversion to emerging markets, non-residents made smaller purchases of dinar securities and, guided by higher returns, focused more on longer-maturity securities (three, seven and ten years) buying more than a half of the overall issue.

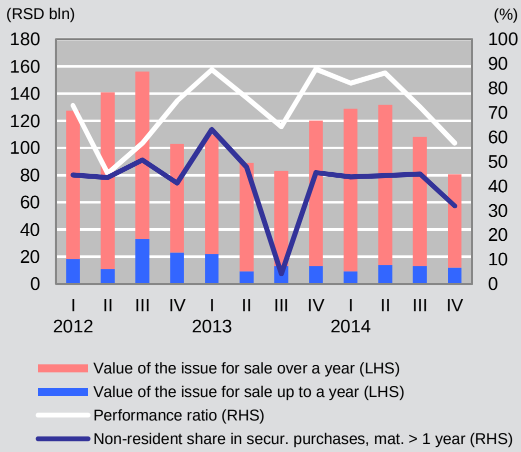
The dinar yield curve lengthened further in October when ten-year bonds were issued – the auction closed at 13.0%, up only by 0.3 pp from the rate achieved a year and a half earlier at the first auction of seven-year bonds.

During 2014, the government also organised 26 auctions in euro-denominated securities. In April, ten-year securities were issued for the first time, at the rate of 5.5%. As the rates were on a downward path in this market as well, most notably in December, demand outstripped supply. At the year-level, rates on one-year securities fell the most (by 1.0 pp to 2.5%) and rates on five-year securities the least (by 0.1 pp to 5.0%).

Interest rates in the secondary market of dinar securities generally mirrored the primary market rates, moving by the year-end from 6.9% for the remaining seven-month maturity to 12.0% for seven- year maturity. Total trading volumes in this market went up by RSD 40.5 bln in 2014 to RSD 286.3 bln, with three- and one-year securities traded the most.

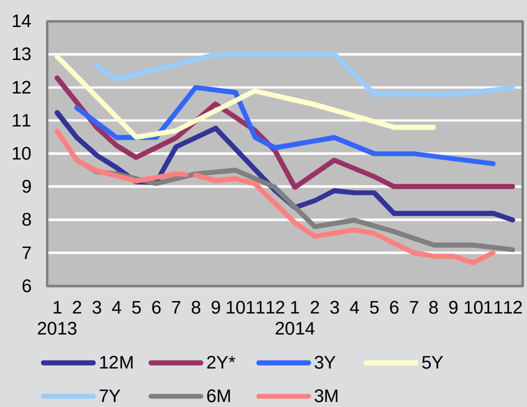
Moving in step with the key policy rate, but also reflecting lower dinar deposit rates, interest rates on dinar loans declined in 2014. The weighted average rate on new

Chart III.3.3 **Primary market of government dinar securities – performance ratio and foreign investor participation**



Source: Ministry of Finance.

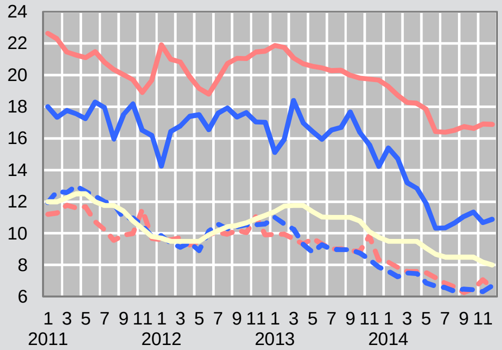
Chart III.3.4 **Interest rates in the primary market of government securities**
(p.a., %)



Source: Ministry of Finance.

* Excluding coupon securities whose interest rate is linked to the NBS key policy rate .

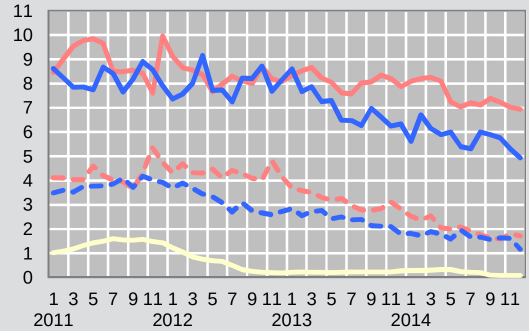
Chart III.3.5 **Interest rates on new dinar loans and new corporate and household deposits***
(weighted average values, p.a., %)



Source: NBS.

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

Chart III.3.6 **Interest rates on FX loans and corporate and household deposits***
(weighted average values, p.a., %)



Source: NBS and European Banking Federation.

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

** Euro and euro-indexed.

dinar loans equalled 12.6% in December, down by 4.5 pp from end-2013. The reduction was more pronounced for corporate loans (3.3 pp), with the average cost of loans at 10.9% in December. Though declining as of February, rates on corporate loans fell the most in June (1.6 pp), when banks began to extend subsidised loans with interest capped at 5.45% of which 5% at government subsidy. Citizens also borrowed in dinars, at lower interest rates which fell by 2.8 pp to 16.9% in December. As of June, the structure of new dinar loans changed significantly in favour of corporate loans which were cheaper than household loans. As a consequence, the drop in the average rate outstripped the decline in interest rates on either corporate or household loans.

Despite a cutback in rates on all types of dinar corporate loans, the drop in the average price of dinar corporate lending was due primarily to falling rates on current assets loans (by 2.9 pp to 10.6%). The cost of dinar household lending declined chiefly on the back of falling rates on the most popular, cash and refinancing loans (by 3.0 pp to 16.6%). The cost of consumer and household loans went down as well. In February, within the initiative aimed at a general reduction in prices of banking products, the NBS began to publish data on costs of current account overdrafts by individual banks. On a decline since February, the average rate on overdrafts was lower in December by 3.5 pp compared to end-2013.

The rate on new euro-indexed and euro loans was 5.1% in December, down by 1.4 pp from end-2013. The decline was somewhat more pronounced for corporate loans where the average rate reached 4.9% in December, while the rates on household loans fell to 6.9%. Similarly to rates on dinar loans, a decline was recorded for rates on euro-indexed corporate loans – for current assets, investment and other purposes. An increase was noted only for the rate on the least used – export loans. Rates on FX household loans also declined, to 4.7% on housing, 5.6% on consumer and 10.0% on cash loans at end-2014.

Lending rates declined partly on account of a reduction in deposit rates. This is also confirmed by the results of NBS bank lending surveys, which indicate a decline in costs of bank funding sources. In the course of 2014, weighted average rates on new deposits recorded their lowest values since September 2010, when the current interest rate statistics went on record.

The weighted average rate on new dinar corporate deposits fell by 1.1 pp to 6.8% in December. As banks did not offer much more favourable terms on the occasion of the World Savings Day in 2014 either, the rates on dinar and FX savings increased marginally in this period, only to decline anew in December. Thus the rates on dinar savings fell by 1.8 pp to 6.5%, whereas the rates on term euro household savings were down by 1.1 pp to 1.7%. The drop in rates on euro corporate deposits was somewhat lower (0.6 pp) – in December these rates averaged 1.2%.

Risk premium

Measured by EMBI and in terms of the period-end and period-average, risk premia of the majority of countries in the region were lower than in 2013. In terms of the period-end, the strongest fall was recorded for Turkey (84 bp), whilst EMBI for Serbia fell by 62 bp. Serbia saw the sharpest drop in the average annual risk premium (112 bp), while it was only Turkey that experienced a rise (around 10 bp).

Following a temporary increase in January, risk premia declined across the region, in response to the Fed's decision to start QE tapering.

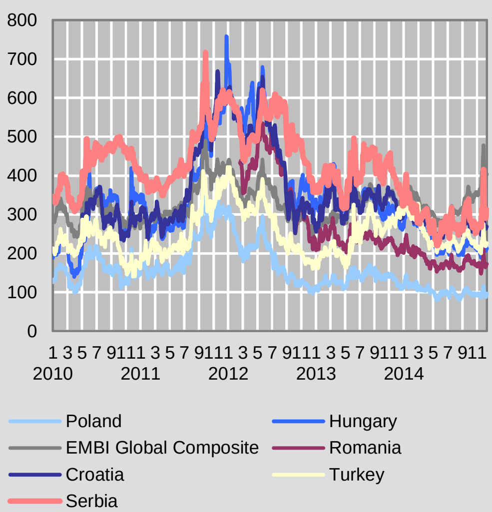
The sharpest drop in regional risk premia came about in May, as a result of a larger drop in returns on government securities across the region than on US treasury securities. The decline continued in June after the news was received that the ECB would engage in further monetary policy accommodation. Serbia's risk premium then touched its annual low (220 bp), i.e. it was at its lowest since November 2007.

By late September and early October, the risk premia rose, on account of expectations of the normalisation of the Fed's monetary policy, encouraging news about the US macroeconomic indicators and unfavourable signals regarding the euro area recovery.

Q4 saw significant volatility of EMBI in the region due to the vigorous decline in global oil prices, geopolitical tensions and dollar's appreciation. In mid-December, Serbia's risk premium touched its historical high of 416 bp. However, it was on a decline until the year-end and reached 312 bp on the last day of December.

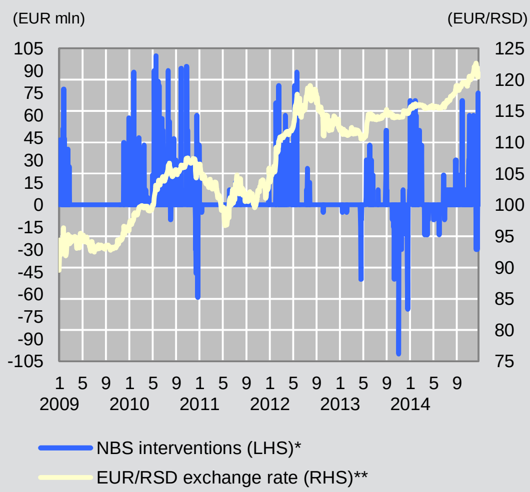
In January, Fitch lowered Serbia's credit rating by one notch – to B+. This, however, did not reflect on EMBI, as it was neutralised by the announcements of an arrangement with the IMF and the start of negotiations on Serbia's EU membership. In early July, Fitch affirmed Serbia's rating at B+, while in April Standard & Poor's affirmed Serbia's rating at BB-.

Chart III.3.7 **Risk premium indicator – EMBI by country**
(daily data, bp)



Source: JP Morgan.

Chart III.3.8 **Movements in EUR/RSD exchange rate and NBS FX interventions**



Source: NBS.

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

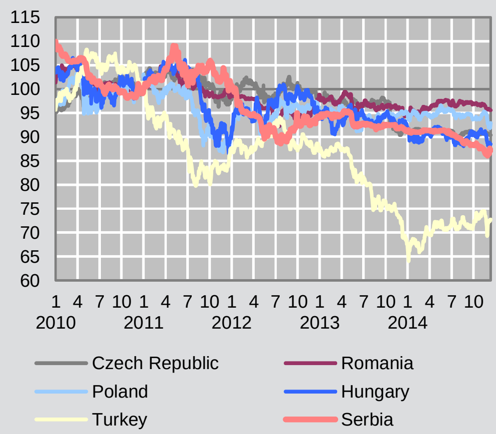
Trends in FX market and exchange rate

Like the majority of currencies of countries in the region running the same exchange rate regime, in 2014 the dinar weakened by 5.2% against the euro end-of-period, or by 3.6% on average compared to 2013. After the January depreciation, the dinar was relatively stable against the euro, up until the beginning of July when it began to gradually weaken. The weakening lasted through most of H2. Thus, in 2014 the value of the dinar ranged between 114.8 and 122.6 for one euro.

The dinar weakened by 16.4% vis-à-vis the dollar end-of-period, mainly due to euro's depreciation against the dollar. In terms of period-average, the dinar's weakening against the dollar was less pronounced (3.8%).

In 2014, the dinar was exposed most of the time to depreciation pressures emanating both from the international and domestic environments. Despite the low current account deficit, in an environment of a modest FDI inflow and smaller inflow from exchange operations, depreciation pressures in early 2014 were generated primarily by elevated FX demand of energy importers and non-residents. Although expected, the Fed's decision to start with QE tapering as of January caused a temporary rise in the risk premium and the emergence of depreciation pressures across the region, particularly in January. The dinar lost 1.1% in the same month, while some other currencies recorded significant depreciation despite central bank interventions. Moderate appreciation pressures emerged in Q2, mainly on account of increased non-resident investment in government securities. Against the background of a global reduction in risk aversion and the expected further monetary policy accommodation by the ECB, foreign investors bought a significant amount of dinar government securities in the primary market in May and June and, unlike in early 2014, acted as the net FX sellers.

Chart III.3.9 **Movements in exchange rates of national currencies against the euro***
(daily data, December 31, 2010 = 100)



Source: NBS and websites of central banks.

* Growth indicates appreciation.

Turbulences in international markets emerged anew in mid-2014 due to geopolitical tensions in Ukraine, introduction of sanctions against Russia and sluggish economic recovery of the euro area, which negatively affected foreign capital inflow and Serbia's exports. Domestic factors, notably higher FX demand of energy importers caused by the May floods and uncertainties as to the scope and intensity of fiscal consolidation and structural reforms, additionally weakened the dinar. At the same time, to maintain the matching currency composition of their claims and liabilities, banks generated FX demand through most of the period and used a part of purchased FX to reduce their foreign obligations. In addition, FX demand increased after dividends were paid to foreign owners in late November and early December. Pressures on the dinar weakened in late 2014, on the back of the disbursement of several larger FX-indexed loans, reduced dinar liquidity of banks and the adoption of additional fiscal consolidation measures.

The already low trading volumes in the IFEM contracted further in H1. However, H2 saw an increase in interbank trading volumes, which reached their highest average value in December (EUR 53.6 mln) since June 2013. Still, despite this recovery, the average daily volumes in this market[11] in 2014 were by 27.2% lower than in 2013 and came at EUR 26.4 mln. Mirroring the trading volumes in the IFEM, exchange rate volatility[12] went up in H2.

In 2014, the NBS intervened in the IFEM both on the purchase and sale side in order to alleviate excessive short-term volatility of the dinar, without any intention to

[11] Excluding the NBS.

[12] Measured by EWMA (Exponentially Weighted Moving Average) and EGARCH (Exponential General Autoregressive Conditional Heteroskedasticity) .

influence its trend. It sold total EUR 1,880.0 mln (mostly in Q1 and Q4) and bought EUR 260.0 mln (mostly in Q2).

Stock exchange trends

Indices of the Belgrade Stock Exchange (BSE) were rising until late 2014. In early December, they reached their highest annual values – at end-December BELEX15 equalled 667.0 and BELEXline 1,344.8 points. Up by 19.5% and 21.7% in 2014, they were among the best performers in the region.

In contrast to indices, total trading volumes on the BSE underperformed relative to earlier years, on the back of reduced trading in shares, notably in the open market. Total trading in shares equalled RSD 15.6 bln, down by RSD 12.9 bln from the year before. At the same time, 62% of trading in shares (RSD 9.7 bln) related to the most liquid shares, included in the BELEX15 basket.

Foreign investors were net sellers of shares worth RSD 0.7 bln, on account of the January net sale. In all other months, they were more active on the purchase side.

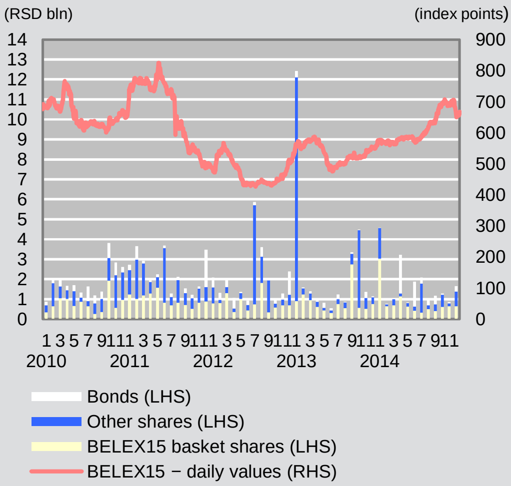
By contrast to shares, total trading in frozen FX savings bonds increased significantly. It equalled RSD 4.7 bln in 2014, which is three times more than in 2013. Record trading volumes were achieved in April and June, most notably for A2014- and A2015-series bonds. Relative to end-2013, rates of return on A2015- and A2016-series declined by 0.9 pp to 2.8% and 2.9% respectively.

In December, the City of Šabac issued municipal bonds through a public offering, which marks a positive step forward in the development of the domestic capital market, this issue being the first of its kind (so far, three local self-governments have issued bonds, but for pre-defined buyers). The issue worth RSD 400.0 was sold out at the fixed interest of 6.0%. The bonds are euro-indexed with a seven-year term. Interest will be paid annually – as of the first year, and the principal as of the third year. In early 2015, the bonds were admitted to trading on the BSE open market.

In 2014, corporate bonds were not traded on the BSE.

BSE market capitalisation expanded by RSD 23.9 bln to reach RSD 796.6 bln in late 2014. Of this, regulated market capitalisation was up by RSD 15.6 bln to RSD 450.2 bln, and MTP[13] capitalisation by RSD 8.4 bln to RSD 346.4 bln. As a result, the share of market capitalisation in estimated GDP edged up by 0.6 pp to 20.5% in late December.

Chart III.3.10 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

4. Money and loans

Reserve money

Dinar reserve money increased in 2014 by 7.6% in nominal and 5.8% in real terms. As bank FX deposits with the NBS contracted following amendment of required reserve regulations, total reserve money declined by 5.0% in nominal and 6.6% in real terms in 2014. In absolute terms, dinar reserve money gained RSD 26.2 bln and FX deposits fell by RSD 58.5 bln, resulting in a RSD 32.2 bln decline in total reserve money.

In 2014, banks' investment in repo securities declined by RSD 102.5 bln which, together with payment transactions with Kosovo and Metohija (RSD 43.0 bln), contributed most to dinar liquidity creation. Around the middle of the year, the government increased balances in its dinar accounts by a considerable amount, which acted in the direction of liquidity withdrawal. Dinar balances in

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

government accounts increased in H2 thanks to improved collection of tax revenues as part of efforts to suppress informal economy. During the closing months of the year, the government increased its spending (in November, and particularly, in December) and at annual level, acted in the direction of liquidity creation (RSD 29.4 bln). The bulk of dinar reserve money was withdrawn through NBS interventions, i.e. sale of foreign exchange in the IFEM (RSD 174.7 bln), mostly during Q1 and Q4.

Within reserve money, dinar allocations of calculated required reserves increased most in 2014 (RSD 13.1 bln) following amendment of required reserve regulations prescribing higher dinar allocations. Currency in circulation also went up (RSD 8.0 bln), as did balances in local authorities' accounts with the NBS (RSD 6.5 bln). Excess dinar reserves[14] contracted by RSD 1.4 bln, mostly on account of lower excess deposits held by banks with the NBS.

Monetary aggregates M1, M2 and M3

As a result of increased dinar deposits, notably of the corporate and household sectors, money supply continued rising in 2014, though its growth was lower than in 2013. In 2014, transaction deposits gained RSD 34.6 bln, while savings and time deposits went up by RSD 24.0 bln; as a result, dinar monetary aggregates M1 and M2 gained 11.0% and 12.2%, respectively, in nominal, and 9.1% and 10.3%, in real terms. With FX deposits also rising by EUR 144.2 mln, the broadest monetary aggregate gained 8.6% in nominal and 6.8% in real terms. The largest contribution to M3 growth came from banks' purchase of government securities, and, from June onwards, after a longer period of time, also from lending to the private sector.

The rise in dinar deposits of both shorter and longer maturities reflected primarily an increase in balances on corporate and household accounts. Balances in accounts of non-profit institutions also increased moderately, while OFO deposits were the only to shrink. Higher corporate account balances, notably of enterprises within the trade, transport and manufacturing sectors, resulted partly from the disbursement of subsidised loans during H2. The upward trend in dinar household savings extended from 2013 up until July 2014, when they reached RSD 40.1 bln. However, this increase was halted in H2 due to

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

	Dec. 2013	Dec. 2014	Changes in 2014
Net foreign assets	**1,204,030**	**1,181,851**	**-22,179**
Net FX reserves	1,202,618	1,179,936	-22,682
Gross FX reserves	1,282,707	1,198,357	-84,350
IMF loans	-80,089	-18,421	61,668
Other net foreign assets	1,412	1,915	503
Net domestic assets	**-562,321**	**-572,388**	**-10,067**
Net domestic NBS loans	-348,660	-278,220	70,440
Net loans to government[1)]	-236,121	-256,415	-20,294
Government loans	1,166	1,223	57
Government deposits	-237,287	-257,638	-20,351
Net claims on banks	-109,912	-6,889	103,023
Loans to banks	120	625	505
Repo operations	-110,000	-7,500	102,500
Other securities	-32	-14	18
Loans to public enterprises	0	1,183	1,183
Loans to non-bank financial institutions	5,245	2,562	-2,683
Loans to other sectors	2,125	1,168	-957
Term and restricted deposits	-9,997	-19,829	-9,832
Other net assets	-213,661	-294,168	-80,507
Reserve money	**641,709**	**609,460**	**-32,249**
Dinar reserve money	344,460	370,690	26,230
Currency in circulation	122,439	130,468	8,029
Dinar reserves of banks	199,881	211,628	11,747
Required reserves	144,989	158,126	13,137
Excess reserves	54,892	53,502	-1,390
Other deposits of other sectors	2	2	0
Local government deposits	22,138	28,592	6,454
FX bank deposits	297,249	238,770	-58,479

1) Excluding local government authorities.
Source: NBS.

relatively low household income. FX household savings also went up in 2014, though less than in the prior years, by EUR 107.6 mln. FX deposits of other sectors, notably corporate, increased as well, with balances in OFO accounts the only to decline.

Bank lending

Unfavourable tendencies in lending activity continued into the first five months of 2014. Still, as of June, lending entered the recovery path owing to the new subsidised loan scheme. Thus, the y-o-y downturn in domestic lending slowed to 0.6% in late 2014, at the

[14] Including balances in bank gyro accounts, vault cash and overnight deposits with the NBS.

programme exchange rate[15]. Excluding receivables of delicensed banks from banks' loan receivables, lending activity recorded a mild y-o-y growth in December (0.5%). The share of domestic loans in estimated GDP increased by 1.7 pp to 48.4%.

In 2014, corporate lending declined by 1.4% at the programme exchange rate. During most of H1, banks' loan receivables were on a decline due to lower volume of newly extended loans, delicensing of Univerzal banka, falling due of earlier approved subsidised loans and the assignment of loan receivables to non-bank entities. The y-o-y decline in lending activity started to decelerate more notably in June when banks began to extend subsidised liquidity and current assets loans.[16] According to data provided by the Development Fund of the Republic of Serbia, subsidised loans worth a total of RSD 136.1 bln were approved. Drawdown of a number of larger loans to public enterprises in late Q4 also fuelled lending activity growth. During 2014, more than a half of newly approved corporate loans (56%) were granted for financing of current assets. Approval of investment loans was modest, due to adverse economic circumstances and uncertainty over future developments (around 16%).

According to NBS bank lending surveys,[17] banks tightened the corporate lending standards in 2014. Although costs of financing were lower, banks decided to tighten the standards considering the estimated risks relating to the collection of receivables and collateral, and an unfavourable outlook for future economic activity. Terms of borrowing by the corporate sector were more favourable because of lower margins and accompanying costs, while bank criteria regarding collateral, maximum amount and loan repayment periods were tightened. On the other hand, following a decline in Q1, corporate demand for loans increased through the rest of the year. This increase was driven primarily by SMEs, and guided by the need to restructure debts and finance current assets.

Contrary to the corporate sector, household lending increased throughout the year, though its growth slackened in Q4 with the start of implementation of fiscal consolidation measures. In 2014, bank receivables in respect of household loans increased by 3.7%, at the programme exchange rate, with cash and refinancing loans dominating new loans. The volume of approved housing loans was lower than a year earlier due to lower household income, adverse tendencies in the real estate market and tighter bank standards. At the same time, a smaller portion of housing loans (RSD 3.7 bln) referred to the subsidised segment and the disbursement of loans approved in late 2013. The use of the least popular consumer loans rose marginally. Households borrowed somewhat less under costlier loan categories (credit cards, current account overdrafts and revolving loans) than before.

As indicated by bank lending surveys, banks eased lending standards for households in H1. However, contrary to previously stated expectations, in H2 a

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

	Dec. 2013	Dec. 2014	Changes in 2014
Net foreign assets	**846,701**	**1,036,784**	**190,083**
Bank net foreign assets	-357,329	-145,067	212,262
Net domestic assets of the banking sector	**870,180**	**828,659**	**-41,521**
Net domestic loans	1,919,806	2,048,254	128,448
Net claims on government	48,890	122,670	73,780
Government loans	337,186	458,250	121,064
Government deposits	-288,296	-335,581	-47,285
Loans to other non-government sectors	1,870,916	1,925,584	54,668
Loans to households	674,534	725,455	50,921
Loans to corporate sector	1,111,301	1,140,200	28,899
Loans to other financial corporations	49,809	23,588	-26,221
Loans to local authorities	34,361	35,246	885
Loans to non-profit and other organisations	911	1,095	184
Other net assets	-1,049,626	-1,219,595	-169,969
Money supply M3	**1,716,882**	**1,865,443**	**148,561**
Money supply M2	547,566	614,259	66,693
Money supply M1	388,265	430,915	42,650
Currency in circulation	122,439	130,468	8,029
Transaction deposits	265,826	300,447	34,621
Dinar savings and term deposits	159,301	183,344	24,043
FX deposits	1,169,316	1,251,184	81,868

Source: NBS.

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

[16] Loans with the maturity of up to 18 months and a six-month grace period are extended in dinars (without a currency clause) at the annual rate of 5.45% – with the government subsidising interest at 5%. Of the loans extended by a bank within the programme, no more than 15% may be used for refinancing loans with that bank. Also, the amount of loans extended to large enterprises is capped to 20% of total loans approved.

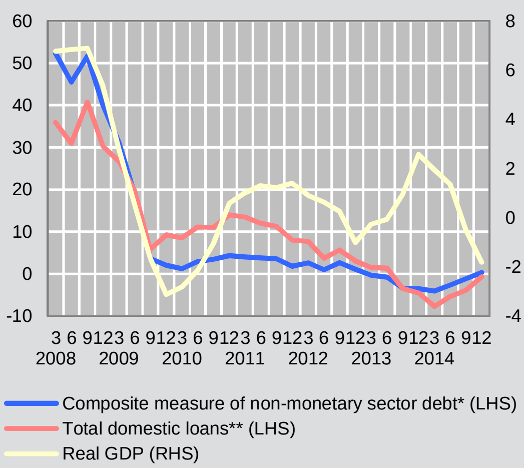
[17] The NBS has conducted the above survey on a quarterly basis since early 2014. Participation is voluntary and the response rate is almost 100%.

number of banks tightened their standards, guided by the same reasons as in the case of corporate lending. Banks offered more favourable repayment periods, with further lowering of accompanying costs, and in Q4 they also relaxed criteria with regard to collateral. Demand was on a rise throughout 2014, led chiefly by the need to refinance existing obligations, while low household income and unfavourable situation in the labour and property markets had a negative impact on households' decision to borrow.

Under the gross principle, the share of NPLs in total loans contracted by 0.2 pp in 2014 to 21.5% in December, as a result of a mild increase in lending and write-off and collection of a part of NPLs. The share of corporate NPLs increased by 0.1 pp to 24.6%, while household NPLs rose by 0.9 pp to 10.3%.

However, despite the high NPL share in total loans, the capital adequacy ratio of 20.0% indicates unimpaired stability of Serbia's banking sector. Total allowances for loan impairment came to 58.9% of NPLs in December, while loan loss provisions,[18] at 114.5% in December, still fully covered the amount of gross NPLs.

Chart III.4.1 **Lending activity and GDP**
(y-o-y rates, %)



Source: NBS and SORS.

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

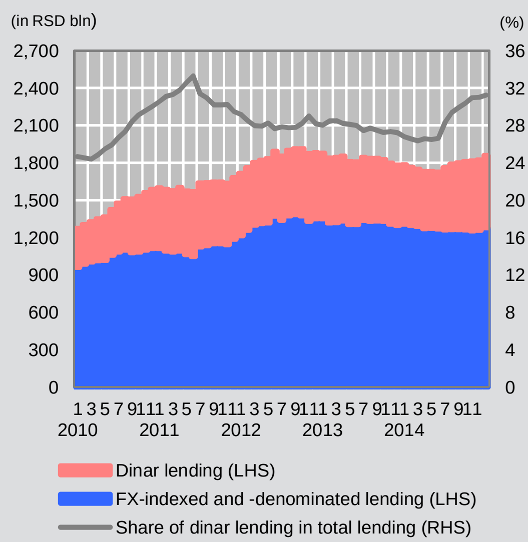
** At programme exchange rate.

5. Dinarisation

Serbia's dinarisation strategy rests on activities that can be grouped under three interconnected pillars. The first pillar includes activities designed to create a macroeconomic environment featuring low and stable inflation, alongside sustainable economic growth and a stable financial system. The second pillar consists of measures to actively promote dinar-denominated instruments and markets, with special emphasis on the development of the dinar bond market. The third pillar aims to promote hedging against foreign exchange risks in the non-bank sector and to discourage their further build-up.

Recognising the need to increase the use of the dinar in the financial system in order to strengthen the country's financial stability, lessen the exposure of the most vulnerable sectors of the economy to the currency risk, reinforce the efficiency of monetary policy and, by extension, create preconditions for strong and sustainable economic growth, in April 2012 the NBS and the Government signed the Memorandum on the Strategy of Dinarisation of the Serbian Financial System[19].

Chart III.5.1 **Share of dinar lending in total corporate and household lending**



Source: NBS.

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

[19] http://www.nbs.rs/export/sites/default/internet/latinica/90/dinarizacija/MemorandumVladaDinarizacija_20120406.pdf

During 2014, through its required reserves policy, the National Bank of Serbia continued to stimulate banks to use dinar sources of funding. Namely, despite the trimming of the required reserve ratio, the ratios on dinar sources are still lower than on FX ones, and the NBS pays interest to banks on allocated dinar required reserves only.

The NBS continued to work on further development of basic FX hedging instruments. During 2014, regular two-week and three-month FX swap auctions were organised, encouraging interbank swap trading and development of instruments for liquidity management and FX hedging.

The government gave a further boost to dinarisation of the financial system in June 2014, when a new subsidised lending programme was initiated. These loans were approved in dinars only, and without a currency clause.

In October 2014, the Republic of Serbia issued a ten-year dinar bond for the first time, thereby lengthening the dinar yield curve and contributing further to the development of the primary and secondary market of dinar securities.

During 2014, the degree of dinarisation, measured as a share of dinar lending in total corporate and household lending, increased from 26.8% at end-2013 to 31.2% at end-2014.

The degree of dinarisation increased in 2014 as dinar lending went up (by RSD 103.6 bln), mostly due to the implementation of the subsidised lending scheme which, in June, put a halt to several years' trend of decline in the share of dinar loans to the corporate sector. As FX and FX-indexed corporate lending decreased, the share of dinar lending in total corporate lending gained 5.0 pp during 2014 to reach 25.0% at year-end.

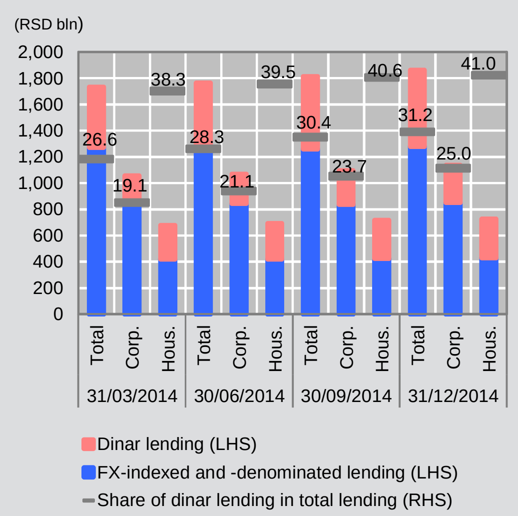
Household dinar lending also rose substantially (by RSD 41.5 bln), mostly in respect of cash loans, while FX and FX-indexed household lending recorded a much more modest growth (RSD 9.6 bln). As a result, the degree of dinarisation of household lending increased by 3.1 pp to 41.0% at end-2014.

Excluding the exchange rate effect[20], the degree of dinarisation rose from 26.8% in late 2013 to 32.4% in December 2014.

6. Aggregate demand

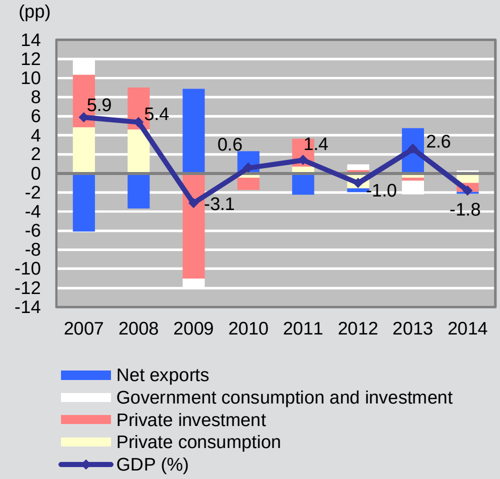
In 2014, aggregate demand edged down by 1.8%, mostly on account of shrinking private consumption and

Chart III.5.2 **Lending by sector**



Source: NBS.

Chart III.6.1 **Contribution to annual GDP growth rate – expenditure side**



Source: SORS and NBS calculation.

[20] At the constant exchange rate of December 2013.

Table III.6.1 **GDP distribution in 2014**

	Growth rates (%)	Contribution to GDP growth (pp)
GDP at constant, previous year prices	**-1.8**	**-1.8**
Domestic demand	-1.5	-1.6
Total final consumption	-1.0	-1.0
Private consumption	-1.3	-1.0
Government consumption	0.1	0.0
Investment	-3.5	-0.7
Fixed investment	-2.7	-0.5
Private investment	-4.8	-0.8
Government investment	13.6	0.3
Change in inventories	-	-0.2
Net exports (exports - imports)	-1.3	-0.2

Source: SORS and NBS calculation.

investment. Net exports gave a mild negative contribution to aggregate demand, final government consumption had a neutral effect, while government investment was the only positive contributor.

Observed by quarter, aggregate demand stagnated in Q1 (0.1% s-a) and declined in both Q2 and Q3 (0.9% and 1.4% s-a, respectively) due to floods and deceleration of external demand. However, positive trends were recorded late in the year and GDP upped by 0.4% s-a in Q4, mostly owing to the recovery of net exports.

Domestic demand

The implementation of fiscal consolidation measures depressed domestic demand by 1.5% in 2014. Among the components of domestic demand, austerity measures reflected the most on household consumption, which declined by 1.3%, giving a negative contribution to total demand (1.0 pp). The shrinking of household consumption is signalled primarily by lower imports of consumer goods, but also by the real decline in main sources of spending – the wage and pension bill and remittances from abroad.

The fall of private investment extended into 2014 (4.8%), giving a negative 0.8 pp contribution to total demand. Such trends are confirmed mainly by lower imports of equipment and smaller number of effective hours worked in construction. On the other hand, positive signals of a possible rebound in investment in the coming period come from the activity in the construction sector which rose significantly in Q4, as well as from the growth in production of domestic machinery and equipment and construction material.

Final government consumption practically flatlined in 2014 (growth of 0.1%). Wage expenditure decreased due to the ban on public sector employment and introduction of a solidarity tax which was replaced by the 10% wage reduction in November. On the other hand, expenditure for the purchase of goods and services rose on the year before, partially also because of the assistance to the population in flooded areas.

The only component of domestic demand which positively contributed to total demand in 2014 was government investment growing by 13.6% and contributing 0.3 pp. An upturn in government investment can be explained by higher budget allocations for rehabilitation of infrastructure in flood-stricken areas and settlement of overdue obligations related to capital expenditures.

Net external demand

Slower growth of the economies of our main foreign trade partners decelerated growth in Serbian exports down to 3.9% in real terms in 2014 (compared to 21.3% in 2013). Also, low domestic demand and fiscal consolidation measures weighed down on real imports of goods and services (deceleration to 3.3% in 2014 relative to 5.0% in 2013), though stronger real deceleration was prevented by increased energy imports due to consequences of flooding and lower import prices reflecting a sharp fall in prices of oil and primary commodities in the global market. Although real exports grew faster, higher share of real imports in GDP led to a mildly negative contribution of net exports to total demand in 2014 (0.2 pp).

Nevertheless, Q4 saw some positive signals of net exports recovery. Real growth of goods and services exports gained 4.7% s-a in Q4 on account of acceleration of euro area GDP growth. Furthermore, real effective exchange rate of the dinar depreciated as of mid-year, boosting price competitiveness of domestic exports. Total depreciation of the real effective exchange rate of the dinar equalled 6.0% in 2014, aided by the nominal depreciation[21] of 7.6%, which was partially neutralised by the faster growth of domestic relative to foreign prices (1.7%).

Commodity exports in euro terms upped by 1.2% in 2014, primarily owing to the growth in exports of agricultural and food products following a successful agricultural season. The most important agricultural export product in 2014 was corn, exported at the record level of 2.4 mln tons, three times its volume in 2013. An upturn in commodity exports was recorded also in other export-oriented branches of industry – electrical equipment, petroleum products and tobacco products. In terms of major export branches, the opposite trend of exports reduction was recorded for motor vehicles (4.8%) and chemical products (14.6%).

In 2014, commodity imports increased by 0.5% in euro terms. The entire growth referred to imports of unclassified goods, while other categories posted a decline. Imports of raw materials dropped by 4.8% as a result of contraction in economic activity, in part induced by the floods. Imports of equipment dropped by 8.2%, signalling postponement of investment due to the uncertainty regarding future global economic trends which prevailed over the greatest part of the year. In addition, fiscal consolidation measures, which constrained sources of spending, led to 3.0% lower imports of consumer goods.

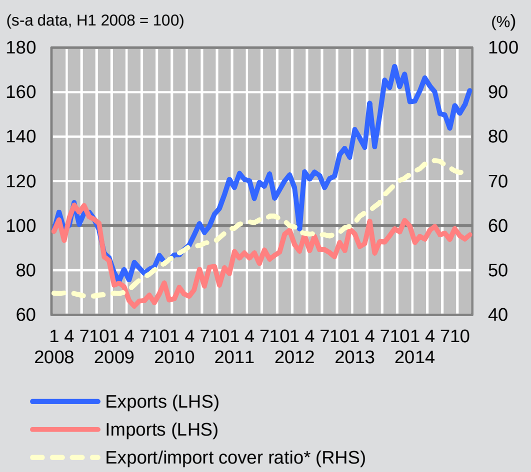
In 2014, current account deficit continued to narrow down, reaching around EUR 2.0 bln or 6.0% of GDP. Foreign trade deficit fell by 5.2% owing to goods and services exports rising faster than imports, while export/import cover ratio slightly increased (0.9 pp), to 72.4%[22] in December. At end-2014 commodity exports were 57.1% above and imports 6.0% below their pre-crisis levels[23] .

7. Economic activity

In 2014, GDP was largely influenced by the May floods, as indicated by the dynamics of its movement throughout the year. GDP stagnation in Q1 (0.1% s-a) was followed by a strong contraction in Q2 and Q3 (by 0.9% and 1.4% s-a, respectively) which reversed in Q4 (growth of 0.4% s-a). GDP fell by 1.8% on an annual basis, ending the last quarter 2.4% below its pre-crisis level[24]. Economic activity measured by NAVA also contracted in 2014 (by 2.4%) and at year-end stood 1.6% below its pre-crisis level.

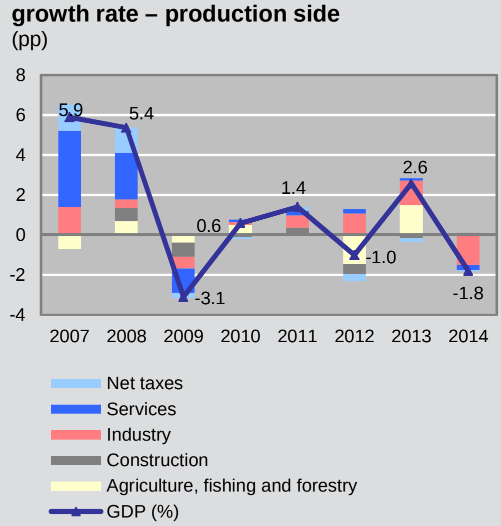
Economic activity declined in 2014 mostly on account of a fall in industrial production (1.5 pp), the sector most

Chart III.6.2. **Commodity trade in euros**



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

Chart III.7.1 **Contribution to annual GDP growth rate – production side**



Source: SORS and NBS calculation.

[21] Geometric average of the nominal EUR/RSD and USD/RSD exchange rates, with 0.8 and 0.2 weights respectively.

[22] 12-month moving average.

[23] H1 2008.

[24] H1 2008.

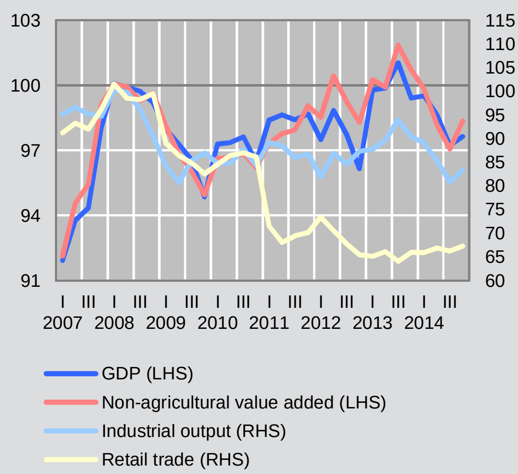
severely affected by floods. Weaker activity was also registered in trade. On the other hand, increased activity in transport, agriculture, information and communication, and construction sectors helped moderate the fall in GDP.

In 2014, gross value added in industry edged down by 7.1%, restrained mainly by developments in the mining and energy sectors, most severely affected by the floods. Apart from direct damage to production capacities, sizeable losses in production also arose from the inability to use parts of production capacities during flood remediation efforts. On an annual basis, physical volume of production shrunk by 16.7% in mining and by 20.1% in energy sector.

Manufacturing was somewhat less exposed to direct negative effects of the floods, its physical volume of production declining by 1.4% in 2014. Lower production resulted primarily from slower growth of our main foreign trade partners, which weighed down on the activity in export-oriented branches of industry. This primarily concerned automobile and oil industries whose strong growth in 2013 reversed into a mild fall in 2014 (by 2.9% and 1.7%, respectively). A significant fall in physical volume of production was recorded in chemical industry, production of metal, textile and leather products. On the other hand, physical volume of production expanded in the production of machinery and equipment, food industry owing to a good agricultural season, and base metals production after reignition of the blast furnace in Smederevo steel plant.

Gross added value in agricultural production increased by 0.8% in 2014. This was mostly prompted by a record high corn and soybean harvest, which surpassed the outturn from the previous season by 35.6% and 19.6% respectively. This led to a decrease in prices of these commodities and also positively reflected on cattle breeding (an increase of 3.0%). Wheat production, on the

Chart III.7.2 **Economic activity indicators**
(s-a, H1 2008 = 100)



Source: SORS and NBS calculation.

Table III.7.1 **Economic activity in 2014**

	Growth rates (%)	Contribution to GDP growth (pp)
Gross domestic product (GDP)	**-1.8**	**-1.8**
Agriculture, forestry and fishing	0.8	0.1
Mining and quarrying	-19.0	-0.3
Manufacturing	-17	-0.3
Electricity, gas, steam and air conditioning supply	-22.5	-0.7
Water supply; sewerage, waste management and remediation act.	-20.0	-0.2
Construction	0.9	0.0
Wholesale and retail trade; repair of motor vehicles and trailers	-3.0	-0.3
Transportation and storage	4.5	0.2
Accommodation and food service activities	-10.0	-0.1
Information and communication	18	0.1
Financial and insurance activities	-3.5	0.0
Real estate activities	-2.0	-0.1
Professional, scientific and technical activities	-19	-0.1
Administrative and support service activities	-19	0.0
Public administration and defence; compulsory social security	0.2	0.0
Education	0.2	0.0
Human health and social work activities	0.2	0.0
Arts, entertainment and recreation	2.2	0.0
Other service activities	2.2	0.0
Activities of households as employers; services-producing act. for own use	2.2	0.0
Gross value added (GVA)	-2.0	-17
Taxes on products minus subsidies on products	-0.6	-0.1

Source: SORS and NBS calculation.

other hand, shrunk by 11.3%, mostly on account of the last year's high base[25]. Fruit, vegetable and grape growing, considerably affected by floods, also posted a decline.

Gross value added in construction upped by 0.9% in 2014, owing to the flood remediation efforts. Increased activity in construction is confirmed by the growth in physical volume of production of construction material (3.1%) and wood processing (12.5%), as well as by the greater number of building permits issued (1.4%) and construction works performed (0.4%) in 2014.

The greatest positive contribution to GDP growth in 2014 came from transport (0.2 pp). Physical volume of services in this sector expanded by 22.1%, mainly as a result of increased physical volume of services in air transport (66.9%). On the other hand, due to flood-induced damages to train rails, physical volume of services in railway transport was lower by 5.2%. Apart from transport, the sector of information and communication also continued to contribute positively to GDP, its gross value added gaining 1.8% in 2014.

Gross value added in trade declined by 3.0% in 2014, giving a 0.3 pp negative contribution to GDP. This resulted from contraction in wholesale trade (4.0%), while retail trade went up (2.0%). Observing other service sectors, lower activity was recorded in accommodation and food service activities, as well as in financial and real estate activities. On the other hand, most sectors associated with the government activity recorded a mild growth.

8. Wages and employment

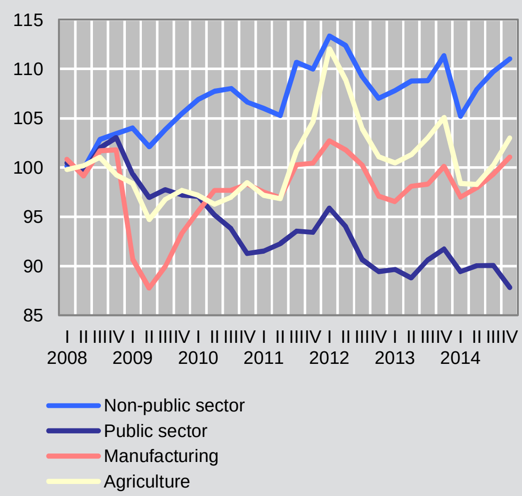
In 2014, wages saw significantly lower nominal growth in comparison to the previous period[26] and edged down in real terms despite significant deceleration in inflation. Also, real net wages in the public sector (1.0%) experienced somewhat sharper fall than those in the non-public sector (0.7%). Fiscal consolidation measures, i.e. a 10% November cut in the public sector wages also contributed to a steeper fall in this sector. Furthermore, subdued economic activity in 2014 and high unemployment stood in the way of a possible rise in wages in the non-public sector.

Observed across activities, real wages in the information and communications sector increased the most (14.2%). They also upped in the sector of administrative and support service activities, construction, manufacturing and electricity, gas and steam supply. On the other hand, agriculture, trade, transport, public administration, education and healthcare witnessed a decline in real net wages.

The average nominal take-home wage was RSD 44,530 in 2014, climbing by 1.4% from 2013. Following a series of fruitless negotiations between trade unions and employers on setting a new minimum wage in Serbia, the Government adopted a decision in September to increase the minimum price of labour to RSD 121 per work hour, excluding taxes and contributions for mandatory social insurance, which will come into effect as of 1 January 2015.

During the period under review, cost competitiveness of the domestic industry somewhat declined, given that unit labour costs rose 8.3%. Still, most of the increase was driven by temporary factors, primarily the flooding, which significantly contributed to a decline in industrial productivity. This is also confirmed by a much higher growth in unit labour costs in mining (30.8%) and energy

Chart III.8.1 **Real net wages**
(s-a, H1 2008 = 100)



Source: SORS and NBS calculation.

[25] In 2013 wheat production recorded a historical maximum of 2.7 mln tons.

[26] Nominal wages rose by 1.4% in 2014, while its average growth measured 8.6% from 2009 to 2013.

sectors (19.4%) versus manufacturing (4.3%), which was least exposed to the effects of the flooding.

According to the Labour Force Survey, conditions in the labour market kept improving in 2014 as well. The unemployment rate fell to 16.8% in Q4 2014, coming down by 3.3 pp from October 2013. Also, employment rate rose to 40.4%, largely owing to informal employment, which upped by 3.9 pp in 2014. Participation rate[27] declined by 1.0 pp in 2014, partly due to an uptick in the number of requests for early retirement submitted before raising of the minimum retirement age.

Total number of the unemployed was lower by 106,875 at end-2014 compared to 2013. The unemployment rate edged down particularly among the youth (15-24 years) – falling from 49.1% in October 2013 to 41.9% in Q4 2014. The situation improved regarding the long-term unemployed, given that their share in the total number fell by 9.2 pp to 66.5%.

According to the Survey, the number of employed persons rose by 65,044 in 2014, with the majority finding employment in activities of households as employers, agriculture and trade, which could indicate that the growth in employment was of a seasonal nature. Employment also rose in education, healthcare and social protection, administrative activities and public administration. A higher number of workers in the mining sector may be explained by additional hiring of people for the purpose of removal of flood consequences. On the other hand, employment fell in high value-added sectors – manufacturing, construction, transport, information and communications and financial activities.

Unlike in 2013, the number of formally employed persons[28] rose by 1,668 in 2014. The rise in employment was entirely due to the higher employment in legal persons (by 5,075), whilst the number of entrepreneurs contracted by 3,407. Formal employment increased most sharply in the sector of trade. Judging by the SORS data, the number of formally employed also rose in information and communications, manufacturing, trade, as well as in the professional, scientific and technical activities, but according to the Survey, these sectors reported a decline. Data contrary to those reported in the Survey were also recorded in education, healthcare and social protection and public administration, which saw a decrease in formal employment. Such opposite trends can be explained by methodological differences between the two sources of data and the dominant role that informal employment played in shaping the labour market trends in 2014.

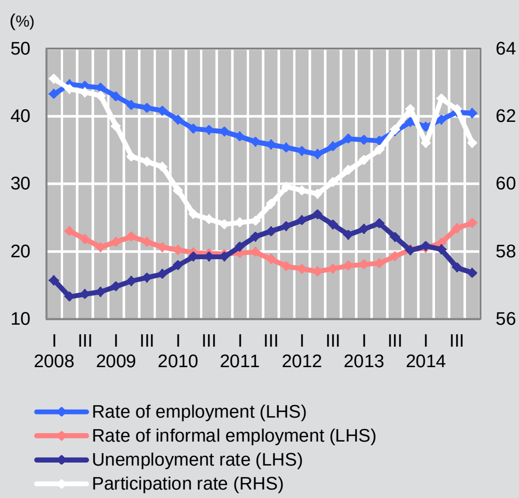
The fall in unemployment reported by the Labour Force Survey was confirmed by the National Employment Service, whose findings showed that the number of the unemployed fell by 27,640 in 2014, arriving at 741,906 in

Table III.8.1 **Employment and unemployment trends**
(in thousands, end of period)

	2011	2012	2013	2014
Formal employment	**1,738.5**	**1,724.3**	**1,703.3**	**1,705.0**
Farmers (according to LFS)	**402.5**	**430.3**	**450.8**	**450.5**
Total employment	**2,141.1**	**2,154.6**	**2,154.1**	**2,155.5**
Total unemployment	**745.2**	**761.5**	**769.5**	**741.9**
First time job seekers	270.2	264.4	267.1	256.3
Workers with previous job experience	475.0	497.1	502.4	485.6

Source: SORS and National Employment Service.

Chart III.8.2 **Labour market indicators under the Labour Force Survey**



Source: SORS.

[27] Measured as the share of active (employed and unemployed) employees in the total number of working-age population (15-64 years).

[28] RAD Survey carried out by the Statistical Office of the Republic of Serbia.

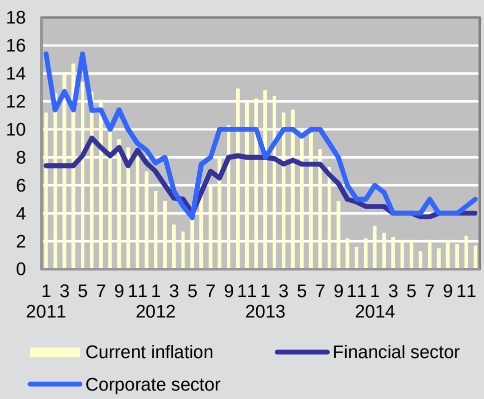
December. The drop in unemployment was also confirmed by the number of users of unemployment benefits, which counted 55,375 persons in December, 7,847 fewer relative to end-2013.

The new Labour Law, adopted in mid-2014, will bring improvements in the labour market in the following period. The most significant amendments refer to the extension of the maximum length of the fixed-term contract (from one) to two years and the introduction of more flexible forms of work – employment from home and part-time employment, as well as of the severance pay and seniority bonus calculated with respect to the years of service with the last employer. These amendments should reduce costs of new employment and increase the flexibility of the labour market.

9. Inflation expectations

Low inflation and the expected low inflationary pressures in the course of 2014 stabilised inflation expectations of the financial and corporate sectors within the target bounds set by the National Bank of Serbia. One–year ahead inflation expectations of the financial and corporate sectors have been set within the target tolerance band since October and November 2013 respectively. The achieved stabilisation of both short- and medium-term inflation expectations will reduce the costs of achieving price stability in the period ahead.

Chart III.9.1 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, %)



Source: Gallup, Ipsos, Ninamedia and NBS.

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

According to the Bloomberg survey, one-year ahead inflation expectations of the financial sector slid to the target level of 4.0% in January 2014. Their expectations rose to 4.6% and 5.0% in the course of the next two months respectively, remaining stable at the level of 4.5% until the end of the year.

Judging by the Ipsos survey, inflation expectations stood at 4.5% during the first two months of 2014. In March, they drifted down to the target level and stood stable until June when they were additionally lowered to 3.8%, which is the level they kept in July as well. Thereafter, inflation expectations rose to the central value of the inflation target (4.0%) and remained unchanged until the end of the year[29]. Inflation expectations of the corporate sector moved within the target band throughout the year save for January when they rose to 6.0%. They slid to 5.5% in February, and further down to the target level in March, staying there until the end of the year, except in July and December when they climbed to 5.0%.

One-year ahead inflation expectations rose only in the household sector. Despite the fact that household expectations are generally higher than those of the financial and corporate sectors which are better informed about the macroeconomic movements, it should still be noted that the survey on the household sector underwent some methodological changes. Up until the March survey, respondents were asked about the inflation prospects only once they were presented with the data on the current inflation. However, since March they are not provided with the information about the current inflation rate, which was the prime reason why their expectations measured 8.0% in March and 10.0% in April, unlike the 5.0% recorded in February. Respondents are now asked to specify the inflation rate they believe was achieved over the previous year (perceived inflation). As such inflation rate, much higher than actual, is above or equal to the rate expected by households for the next year,

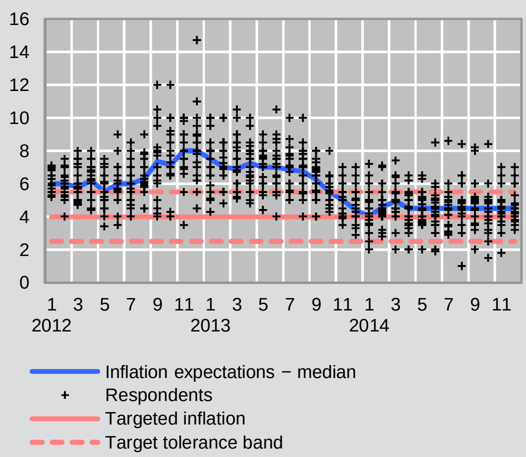
[29] Ninamedia clipping d.o.o. Novi Sad has conducted a survey on expectations of economic entities since December 2014, in accordance with the methodology applied so far.

movements in household inflation expectations can also be assessed positively. This is also confirmed by the qualitatively expressed inflation expectations of households given that the number of respondents who expect the prices to remain the same or rise moderately over the next year was higher than those expecting considerably higher prices.

Medium-term inflation expectations, i.e. expectations for two years ahead, of both the financial and corporate sector, have been within the target band since March 2014 when this question was introduced and stayed unchanged up to June. Then the financial sector pared back its expectations from 4.5% to 4.0%, and kept them there with minimum changes until the end of the year. Corporates lifted their expectations up from 4.0% to 5.0% in June, and then further up to 6.0% in July. After that, expectations subdued and hovered from 4.0 to 5.0%

Following low levels recorded late last year, the dispersion of responses widened across all sectors in H1. Greater disagreement of respondents regarding inflation expectations may probably be explained by uncertainties about the effects of the flooding on inflation. Dispersion

Chart III.9.2 **One-year ahead expected and targeted inflation – financial sector**
(y-o-y rates, %)



Source: Bloomberg and NBS.

dropped across all sectors by the end of the year thanks to a prolonged period of low current inflation and expected lower inflationary pressures.

10. Fiscal policy

The implementation of fiscal consolidation measures continued in 2014 to prevent the public debt from growing and ensure sustainability of public finances. Unlike the set of measures adopted in late 2012 which mainly focused on the revenue side of the budget, new measures envisaged that the deficit reduction should primarily be based on adjustments on the expenditure side. The cut in pensions and public sector wages and downsizing of the public sector, primarily through enhancement and corporatisation of state owned enterprises are envisaged as the key fiscal consolidation measures. On the revenue side of the budget, fighting against grey economy and tax evasion are set as the priority tasks. Furthermore, on 1 January 2014 a decision came into force under which the special VAT rate was raised from 8% to 10%[30], and the tax rate on trade and imports of personalised computers and their components lifted from 8% to 20%.

Consolidated budget deficit reached RSD 258.1 bln or 6.7% of GDP in 2014, up by 1.2 pp from 2013. A significant portion of this deficit came from interest expenses (3.0% of GDP). The central government deficit stood at RSD 246.9 bln (6.4% of GDP).

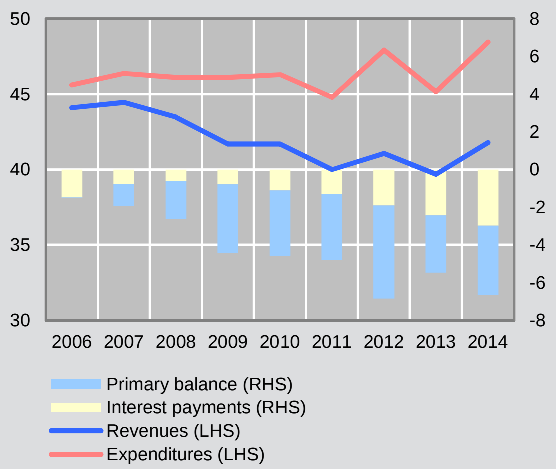
Consolidated revenues in 2014 amounted to RSD 1,620.8 bln, up by 3.2% in real terms compared to 2013. The steepest real increase was recorded for corporate income tax receipts (17.5%) and VAT receipts (5.4%). Higher receipts from corporate income tax can be related to the new, higher tax rate (brought up from 10% to 15%), which is applied as of 2013 to the corporate income, whilst the rise in VAT receipts came entirely from higher receipts from imported goods. These receipts rose by 8.1% in real terms, unlike receipts from VAT on domestic goods, which fell by 0.9% in real terms. It is estimated that such trends come largely as a consequence of the May flooding, reduction in domestic production, increase in imports due to the implementation of the subsidised

[30] The special VAT rate applies on the sale of bread and other baked products, milk and dairy products, flour, sugar, edible sunflower seed, maize, rape, soybean and olive oil, and edible fats of animal and vegetable origin and honey.

lending programme and the depreciation of the dinar in the second half of the year.

The sharpest real decline was recorded for revenues from individual income tax (8.1%) and customs duty (6.5%). In addition to recessionary tendencies in the domestic economy, the reduction in revenues from income tax also came from a rise in the non-taxable part of income and reduction in wage/salary tax[31] (from 12% to 10%) in May 2013. However, this decline was largely compensated by a rise in receipts from social insurance contributions (2.1%), which was the result of an increase in pension and disability insurance contributions (from 22% to 24%) also recorded in May 2013. As regards customs revenues, they are reduced each year on account of implementation of the Stabilisation and Association Agreement with the EU, which is the country's largest foreign trade partner. Last year they accounted for merely 1.9% of total public revenues. Still, given that harmonisation of customs duties is near completion, it is expected that the downward trend in customs revenues will end in the years that follow.

Chart III.10.1 **Fiscal revenues, expenditures and result**
(in % of GDP)



Source: Ministry of Finance and NBS.

Although receipts from excise taxes recorded a 1.6% real growth in 2014, it was entirely the result of higher receipts from excise taxes on petroleum products, i.e. the introduction of petroleum products marking, which *inter* alia, eliminates the grey market. Other excise categories fell in real terms, most sharply excise taxes on tobacco products, and such fall is linked to the still present illicit trade in shredded tobacco.

Consolidated expenditures in 2014 amounted to RSD 1, 878.9 bln, rising by 5.2% in real terms from a year earlier. The sharpest rise was recorded for payments for called guarantees (267.8%) and interest (19.3%), while the rise in expenditures for wages and pensions was halted due to the implementation of fiscal consolidation measures. Instead of the "solidarity tax" on above-average wages, November saw the introduction of the wage and pension cuts in the public sector. These measures envisage a 10% linear cut in wages (exceeding RSD 25,000) in the general government sector, but also in public enterprises and other entities in the public sector. They also stipulate a 22% progressive reduction in pensions (higher than RSD 25,000) and 25% reduction in the part of the pension that exceeds RSD 40,000. The said measures contributed to y-o-y stagnation in expenditures on pensions in real terms, while expenditures on public sector wages recorded a 3.2% drop.

The real increase relative to 2013 was recorded for subsidies (13.2%), capital expenditure (12.6%) and expenditures for the procurement of goods and services (5.0%).

The main sources of funding of the budget deficit were a loan granted by the UAE (USD 1.0 bln), the first portion of the loan from the Russian Federation (USD 300.0 mln) and heavier borrowing in the domestic financial market. Government debt under dinar securities issued in 2014 rose by RSD 117.1 bln to RSD 550.6 bln, while debt under euro-denominated securities went up by EUR 629.3 mln to EUR 1.8 bln.

Total debt of the Republic of Serbia rose by EUR 2.6 bln in 2014, amounting to EUR 22.8 bln at and-2014[32]. At the

[31] Receipts based on the wage/salary tax account for approximately three quarters of the receipts from individual income tax.

[32] General government debt (which, under the Law on the Budget System, apart from the central government debt (the Republic of Serbia) includes non-guaranteed liabilities of local government units) stood at EUR 23.2 bln, at end-2014, accounting for 72.3% of the GDP.

[33] Estimated GDP in 2014.

same time, the share of this debt in GDP[33] rose by as much as 11.4 pp and came to 71.0%, thereby accelerating the growth above the statutory limit of 45%. It is estimated that around 5.0 pp of the said debt expansion comes as a consequence of the palpable strengthening of the US dollar as of mid-2014. Around 80% of the public debt at end-2014 was denominated in foreign currency, with euro and dollar accounting for 41.7% and 31.5% of the public debt respectively.

According to our estimate, it is necessary to continue the implementation of fiscal consolidation measures and structural reforms, not only in order to reduce the volume of public sector borrowing, but also to improve borrowing conditions of the private sector and enable a more adequate re-allocation of financial resources.

Appendix 1: National Bank of Serbia's Letter to the Government of the Republic of Serbia on Reasons Why Inflation Departed from the Target

Belgrade, 12 September 2014

GOVERNMENT OF THE REPUBLIC OF SERBIA

Mr Aleksandar Vučić, Prime Minister

Dear Mr Vučić,

As inflation has been moving below the lower bound of the target tolerance band for six consecutive months, I am writing this letter in accordance with the *Agreement on Inflation Targeting Between the National Bank of Serbia and the Government of the Republic of Serbia* (Section 6, paragraph 4), adopted at the Government session of 19 December 2008, in order to explain why inflation has moved away from the target tolerance band, to describe the measures that will be taken with a view to maintaining inflation within the target tolerance band in the medium term, and to set out the period within which we expect inflation to return within the band.

From March to August 2014, year-on-year inflation was moving below the lower bound of the target tolerance band (4.0±1.5%), measuring 1.5% in August. The weakening of inflationary pressures in the prior period reflects the interplay of several factors, most of all the expectedly low aggregate demand, relatively stable movements in the foreign exchange market and reduced cost-push pressure on food prices. While the disinflationary effect of the first two factors was expected, the drop in food production costs was sharper than anticipated. Besides, the absence of adjustment of electricity prices in the last year also played a role in inflation undershooting.

From March to August 2014, year-on-year inflation averaged 1.9%. The contribution of food prices was negative and equalled 0.9 percentage points. As a result of good agricultural seasons in 2013 and 2014, international and domestic prices of primary agricultural commodities were lower than expected and their disinflationary effect on food prices proved stronger than assumed in our earlier projections.

The absence of adjustment of electricity prices, which was envisaged to take place in the third quarter, also played a part in continuous undershooting of the target tolerance band. In this context and in order to help stabilise year-on-year inflation rates, the National Bank of Serbia has addressed the Government of the Republic of Serbia and presented its proposal for the adjustment of electricity prices according to a pre-defined criterion in the same month each year.

The Executive Board of the National Bank of Serbia has taken all measures within its remit to bring inflation back within the target tolerance band in the medium run. The easing of monetary policy, which started back in May 2013, continued into 2014. From May 2013 to June 2014, the key policy rate was lowered from 11.75% to 8.50%, while the effective rate on one-week repo operations of the National Bank of Serbia has been revolving around 6.5%. Bearing in mind that the disinflationary effect of some factors is temporary (notably low cost-push pressure on food prices) and that geopolitical tensions have a strong impact on the country risk premium and the exchange rate, the National Bank of Serbia must be cautious in the conduct of monetary policy and its efforts to stabilise inflation at low levels in the longer run, while maintaining financial stability at the same time.

In the best collective judgement of the National Bank of Serbia's Executive Board, inflation will return within the target tolerance band until the end of 2014 and will stay therein in the course of 2015. Inflation's return within the target tolerance band will be supported by the waning of the disinflationary pressures from food prices, the anticipated adjustment of electricity prices and the rise in import prices.

As so far, in pursuing monetary policy objectives, the National Bank of Serbia will act responsibly and will seek to contribute to the creation of a stable and predictable business and investment environment.

Yours sincerely,

Dr Jorgovanka Tabaković

Submitted to:
– Mr Rasim Ljajić, Deputy Prime Minister and Minister of Trade, Tourism and Telecommunications
– Mr Dušan Vujović, Minister of Finance
– Ms Snežana Bogosavljević-Bošković, Minister of Agriculture and Environmental Protection

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