ANNUAL MONETARY POLICY REPORT

National Bank of Serbia

2015

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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, 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 2015 was adopted by the NBS Executive Board at its meeting of 9 June 2016.

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:

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Ana Gligorijević, Vice Governor

Veselin Pješčić, Vice Governor

Diana Dragutinović, Vice Governor

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

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[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, 18/2015 and 72/2015.

ABBREVIATIONS

bln – billion
bp – basis point
BRICS – Brazil, Russia, India, China and South Africa
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
IFI – international financial institution
IMF – International Monetary Fund
mln – million
NAVA – non-agricultural value added
NPL – non-performing loan
OFO – other financial organisation
pp – percentage point
Q – quarter
q-o-q – quarter-on-quarter
s-a – seasonally-adjusted
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

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Overview

Inflationary pressures remained subdued in 2015, reflecting the impact of the majority of domestic factors, as well as falling global prices of primary commodities (oil and primary agricultural commodities) and generally low inflation abroad. Like in majority of other European countries, under the overwhelming sway of the drop in global prices of oil and primary agricultural commodities, year-on-year inflation stayed low, settling at 1.5% in December.

Low inflationary pressures, consistent implementation of fiscal consolidation and structural reforms and the conclusion of an arrangement with the International Monetary Fund opened the scope for stronger monetary policy easing in 2015, despite heightened uncertainties in the international financial market. In the course of the year under review, the key policy rate was cut seven times by a total of 350 basis points – from 8.0% to 4.5%. These cuts fed through into lower interest rates in the interbank money and credit markets. In fact, at the end of 2015 the rates on new dinar lending to corporates and households fell to their lowest levels. Together with the release of funds through a reduction in the FX reserve requirement ratios, the decline in lending rates contributed to the recovery of credit activity in the second half of the year. In May, the National Bank of Serbia narrowed the interest rate corridor from ±2.5 percentage points to ±2.0 percentage points relative to the key policy rate.

The confidence of market participants in the measures taken by the National Bank of Serbia is best illustrated by the well-anchored inflation expectations.

The macroeconomic setting for monetary policy in 2015 improved from a year earlier mainly owing to better macroeconomic prospects of the country, and most of all to better balance of payments and fiscal performance. However, 2015 saw numerous downside risks in the international environment.

Early in the year, international financial markets experienced a bout of volatility amid uncertainty over the monetary policy moves of leading central banks, the collapse of global oil prices and other primary commodities, as well as due to geopolitical tensions. The markets calmed down and global liquidity picked up following the European Central Bank's decision to start the purchase of sovereign securities in March and the Federal Reserve System's deferral of rate hikes for the second half of the year. In late June, the international financial markets were shaken by the crisis in Greece, while in August another blow came from the news of China's slowing growth and the consequent turmoil in the Chinese financial market whose ripple effects were felt strongly in stock markets worldwide. By the end of the year, uncertainties in the international financial markets gathered pace amid investors' reaction to the increase in the Fed funds rate and weaker prospects for global growth.

Emerging countries' risk premia were strongly affected by the volatility in the international financial markets. Though Serbia's risk premium followed the regional dynamics, its sharper decline at year level relative to regional peers was supported by the country's improved macroeconomic prospects, notably reduction of internal and external imbalances, and the conclusion of the precautionary stand-by arrangement with the International Monetary Fund and the positive assessment of its implementation.

Investment into export-oriented sectors, along with the recovery of the euro area – Serbia's key trade partner, had a positive effect on domestic manufacturing in 2015.

This is evidenced by increased activity in 18 and export growth in 20 of the 24 manufacturing industries. This, together with the recovery of mining and energy production capacities from the 2014 flood damage and the robust growth of construction industry, helped Serbia's GDP grow by around 0.74% in 2015. At the same time, headwinds to GDP came from agricultural production affected by unfavourable weather conditions, and also from some of the service sectors.

On the expenditure side, the largest positive contribution to GDP originated from private investment, and in the second half of the year from government investment as well, while household and government consumption, weighed down by fiscal consolidation, worked in the opposite direction. However, household consumption gradually healed in the second half of the year, thanks to higher disposable income stemming from lower costs of loan repayment, increased inflow of remittances and falling oil prices. Investment growth was strongly underpinned by the continued macroeconomic and financial stability, improved business and investment environment, and lower operating costs resulting from lower costs of borrowing and prices of oil.

External imbalances continued narrowing down in 2015, reflecting primarily the implementation of fiscal consolidation measures and structural reforms at home, falling global oil prices and the gradual recovery of external demand. The current account deficit amounted to 4.8% of GDP, down by 1.2 percentage points from 2014. In contrast to previous years, the current account deficit was fully covered by net FDI inflows, which strengthened Serbia's external position. Thanks to significantly higher FDI inflow (EUR 1.8 billion net), but also to lower net repayment of financial credits, unlike in the year before, a net capital inflow was recorded in 2015, which fed through into higher National Bank of Serbia's FX reserves. As a result, end-of-year FX reserves stood at EUR 10.4 billion, covering close to seven months' worth of imports of goods and services.

A significant decrease in fiscal imbalances contributed to public finance sustainability and Serbia's resilience to external shocks. Contracting by almost 3.0 percentage points from 2014, the fiscal deficit amounted to 3.8% of GDP, considerably below the ceiling agreed with the International Monetary Fund. At the same time, the primary deficit did not exceed 0.5% of GDP.

The exchange rate of the dinar was relatively stable in the course of 2015, reflecting reduced internal and external imbalances and increased inflow of remittances and foreign investment in equity capital. Appreciation pressures prevailed for most of 2015, receding however by the end of the year and giving in to depreciation pressures that swelled on heightened uncertainty in the international financial markets and seasonally higher demand for foreign exchange (payment of energy imports). End-of-period, the dinar weakened against the euro by 0.5% in 2015. The National Bank of Serbia carefully monitored and assessed the intensity of external shocks, intervening in both directions in order to ease excessive short-term volatility of the exchange rate. In 2015, the National Bank of Serbia bought EUR 970.0 million and sold EUR 450.0 million in the interbank foreign exchange market. As a result, the Serbian central bank was the net buyer of foreign exchange in the amount of EUR 520.0 million.

One of the significant achievements of Serbia in the past year is the conclusion of the precautionary arrangement with the International Monetary Fund. Three reviews under the arrangement were successfully completed as a result of concerted efforts of the Government and the National Bank of Serbia and full coordination of monetary and fiscal policies. In the coming period too, the National Bank of Serbia intends to take all necessary actions and measures in order to stay current on its commitments under the arrangement. Keeping inflation low and stable in the medium term and maintaining financial stability remain its primary objectives, this being the best way for the central bank to contribute to the country's economic prosperity. Also, the National Bank of Serbia will continue to support economic growth through credit activity to the extent permitted by key inflation factors and risks from the international environment.

I Strategic 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 NBS Monetary Policy Committee[1] 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, 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 and stabilise inflation expectations, the NBS Executive Board has set the medium-term inflation target at 4.0%, with a tolerance band of ±1.5 pp.

The trajectory of targeted inflation reflects the intention to achieve price stability without causing any disruptions to macroeconomic processes. The inflation target remains above the quantitative definition of price stability and the level of inflation targets in advanced economies (2.0% or 2.5%). The set inflation target reflects the assessment that nominal, real and structural convergence to the EU has not been completed yet.

It should be borne in mind that the inflation target is a medium-term objective, i.e. that actual inflation may diverge from the target in the short run due to exogenous shocks. As so far, the NBS will allow 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.

[1] 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.

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 significant 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 2015

Monetary policy easing continued in 2015 – the key policy rate was cut from 8.0% to 4.5%. **Continued monetary easing was facilitated primarily by low inflationary pressures from the majority of domestic factors, consistent implementation of fiscal consolidation measures, the conclusion of a precautionary arrangement with the IMF, as well as by the sharp fall in global prices of oil and other primary commodities**.

After falling to its lowest level in January, y-o-y inflation entered an upward path, but stayed below the lower bound of the target tolerance band throughout 2015. The undershooting of the target tolerance band is largely attributable to the drop in global prices of primary commodities, notably oil, and administered price growth that remained low for the greater part of the year. Price growth was slowed down by the majority of domestic factors, as well as by the generally low inflation abroad. The absence of major inflationary pressures was indicated also by the fact that both short- and medium-term inflation expectations were well-anchored within the target band, this being a key prerequisite for stabilising inflation and increasing the effectiveness of monetary policy measures.

In making the decision to cut the key policy rate, the Executive Board of the NBS took into account that disinflationary pressures were reinforced by tight fiscal policy, which confirmed the commitment of the Serbian economic policy makers to strengthen public finances and ensure public debt sustainability. The budget deficit was almost halved in 2015 – from 6.6% to 3.8% of GDP. The reduction of internal imbalances was complemented by a reduction of external imbalances – the current account deficit was slashed by one fifth and was fully covered by FDI. In conjunction with structural reforms and the conclusion of the arrangement with the IMF, this had a positive effect on the country risk premium and investors' perception of Serbia as a long-term investment destination.

The narrowing of internal and external imbalances was crucial for maintaining the country's macroeconomic stability, given uncertainties in the international environment over several key issues: the pace of global economic recovery, effects of diverging monetary policies, unexpected moves of leading central banks, movements in global oil prices and ongoing geopolitical tensions.

The pace of key policy rate cuts in 2015 was largely determined by developments in the international environment. The key policy rate was kept unchanged in the first two and last two months of the year and in July, whereas in each of the other months, it was trimmed down by 50 bp.

Notwithstanding low inflationary pressures at home, **the key policy rate was kept unchanged in the first two months of 2015** because of the risks that emanated from abroad. The collapse of global oil prices in late 2014 and early 2015 and the geopolitical events diminished the predictability of the monetary policy decisions of the Fed and the ECB and increased uncertainties in the international financial market. An additional blow to this market came in January from the unexpected decision of the Swiss National Bank to remove the 1.20 cap on the Swiss franc against the euro. These circumstances prompted investors to re-examine the risk perception of emerging markets, leading to a rise in their risk premia in early January, including that of Serbia. However, the affirmation of Serbia's credit rating by Fitch and Standard & Poor's owing to the adoption of fiscal consolidation measures, the implementation of structural reforms and the conclusion of a precautionary stand-by arrangement with the IMF, helped halt the increase in the risk premium and reverse the trend in the months that followed. Also, developments in the international environment improved relative to the beginning of the year under the impact of rising global liquidity. To be precise, in order to stimulate economic activity, the ECB expanded its asset purchase programme in March 2015 to include bonds issued by euro area central governments. At the same time, the Fed kept its policy rate unchanged, while hinting at a rate increase in the coming period. Given the low, and even negative yields in advanced economies, high global liquidity and investors' search for higher yields were expected to have a positive effect on capital inflow to Serbia and on the stability of the local foreign exchange market. This, together with expectation of low inflationary pressures on account of the majority of domestic factors, prompted the Executive Board **to lower the key policy rate from 8.0% to 6% in the period March–June.**

In late June, the international financial market was shaken by the Greek crisis and the threat of Grexit. Despite the fact that the escalation of Greek crisis would have had only limited direct effect on the Serbian economy, the Executive Board estimated that there were risks of indirect negative effect through increased volatility in the international financial market. Caution was warranted also by uncertainties over global prices of primary commodities, notably oil, as well as over the effects of the asymmetric exit of leading central banks from monetary accommodation. In its July meeting, the Executive Board therefore **decided to keep the key policy rate on hold**.

In August, China took centre stage in the global economic arena. Upheavals in its financial market spread like virus over stock markets worldwide, and signals of its economic slowdown dented the prospects for global growth. This, of course, reflected on the monetary policy decisions of the Fed and the ECB that largely shape global liquidity. The Fed postponed its rate increase, while the ECB revised down its forecast of euro area growth and hinted at the possibility of further stimulus in December.

In addition to supply-side factors, it was weaker prospects for global growth that helped renew the fall in global prices of oil and other primary commodities in July and August. The twelve-month inflation projection released in August was lower than the one released in May, mainly because of the stronger-than-expected disinflationary effect of the prices of primary commodities. At the same time, the projected economic growth for 2015 was revised from 0.0% to 0.5%, as the decline in consumption turned out to be softer than anticipated. Having this in mind, as well as the possibility that the monetary policies of advanced economies could stay accommodative for longer than expected, the Executive Board **decided to cut the key policy rate by 50 bp in each of its three meetings from August through October, down to 4.5%**.

The inflation projection released in November was revised down relative to August – this time again because of the fall in global primary commodity prices. As regards economic activity, under the November projection, GDP was to grow 0.8% in 2015 and step up to 1.8% in 2016. The 0.3 pp higher GDP growth projection relative to August was due to a faster-than-expected growth in investment. However, given heightened uncertainty in the international environment and the expected effects of past monetary easing, the NBS Executive Board decided **in its November and December meetings to keep the key policy rate unchanged (4.5%)**. In the press releases following those meetings, the Board indicated that monetary policy would remain expansionary in the period ahead because inflationary pressures were likely to stay low. However, the Board underlined that the degree of monetary expansion would depend primarily on the assessment of potential inflationary effect of external risks.

For their major part, external risks related to the uncertain reaction of market participants to the expected increase in the Fed's rate and its effect on commodity and financial markets, especially on capital flows toward emerging economies, Serbia included. Around mid-December, the Fed started the normalisation of its monetary policy. The markets expected the increase in the Fed's rate, but the pace and size of the increase during 2016 remained uncertain, and so did the intensity of its impact on capital flows toward emerging markets, still more so given a further step-up in the ECB's monetary accommodation.

The increasingly certain slowdown in China's economic growth and depreciation of the renminbi fuelled the volatility in the global financial market. Investors worldwide became rather jittery because of the upheavals in Chinese stock markets, but also because of the incoming information on the slowing of its economy, considering China's impact on global growth and demand in the markets of primary commodities. Besides, uncertainties in the international environment were also spurred by geopolitical tensions, notably tensions in the Middle East.

On the other hand, it was expected that external risks would be moderated by the ECB which, following October announcements, eased its monetary policy further in December. Namely the ECB decided to extend its quantitative easing programme by additional six months, until March 2017, and to trim its deposit facility rate by 0.1 pp, to -0.3%.

The NBS monetary policy easing contributed to a significant reduction in the cost of borrowing for the private sector and the government, as well as to the recovery of credit activity from mid-2015 on. In fact, it was in 2015 that interest rates on dinar loans to the private sector recorded their sharpest decline of close to 5 pp, falling at year-end to their lowest market-based levels.

2 Monetary policy instruments

The main monetary policy instrument of the NBS is the key policy rate, i.e. the interest rate the NBS uses in its 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 2015 were one-week reverse repo transactions, i.e. repo sale of securities (liquidity-absorbing).

The NBS implemented repo transactions by selling its own securities. For this purpose, in 2015 the NBS issued one series of bills in the total 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 within the same series and facilitates liquidity management for banks.

There were 45 repo sale auctions in 2015. They were organised on a weekly basis and the securities were offered at multiple variable interest rates. The sales totalled RSD 1,504.7 bln, significantly less than in 2014 (RSD 3,585.8 bln).

The stock of NBS securities in banks' portfolio averaged RSD 28.5 bln in 2015, RSD 42.3 bln less than in 2014. Relative to end-2014, the stock of securities increased by RSD 23.1 bln, to RSD 30.6 bln in late December.

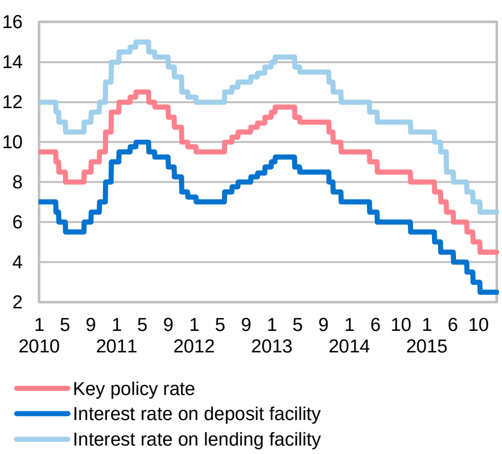
The volume of securities sold increased gradually during 2015, particularly in H2. Total securities sold in H1 amounted to RSD 327.6 bln, and RSD 1,177.1 bln in H2. A significant part of the increase was due to higher dinar liquidity resulting from the NBS's purchases of foreign currency in the IFEM.

Deposit and lending facilities

In 2015, the NBS continued implementing the Decision on Terms and Conditions of Depositing Banks' Excess Liquidity with the NBS which regulates deposit facilities.

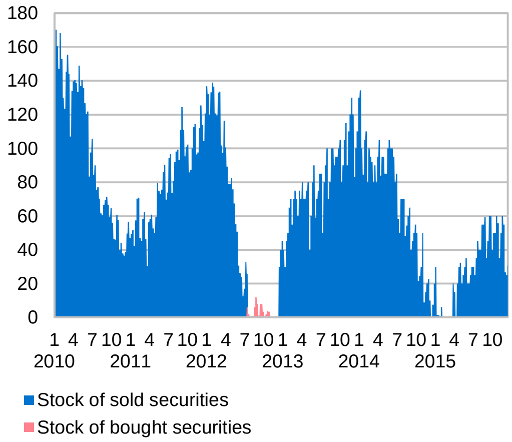
In accordance with this Decision, banks continued to deposit excess liquidity in overnight accounts with the central bank. The average daily balance of bank deposits with the NBS in 2015 was RSD 45.9 bln, up by RSD 30.7 bln from 2014. The highest average balance of deposits was recorded in August (RSD 71.0 bln) and the lowest in February (RSD 10.2 bln).

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



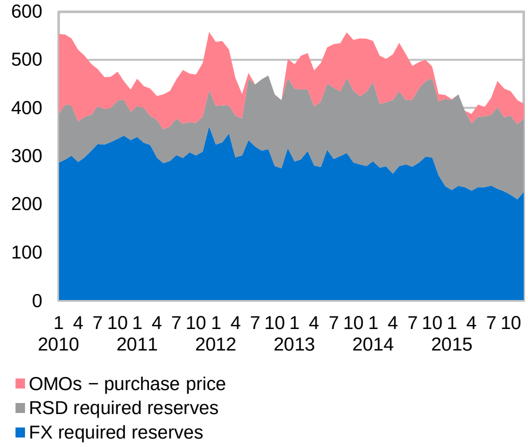
Source: NBS.

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



Source: NBS.

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



Source: NBS.

The NBS also continued implementing the Decision on the Conditions and Manner of Extending Daily Liquidity Loans to Banks against Collateral of Securities, which regulates NBS lending facilities.

During the review period, banks used credit facilities as intraday and overnight loans. Intraday loans amounted to a total of RSD 38.0 bln, of which RSD 21.6 bln were drawn in Q3. Banks drew overnight loans in the total amount of RSD 166.4 bln, of which RSD 151.2 bln in Q3.

Required reserves

The Decision on Banks' Required Reserves with the National Bank of Serbia was amended three times in the course of 2015.

The January amendment to the Decision came after the assessment that an additional cut in the FX reserve requirement ratio i.e. unlocking of banks' credit potential, would serve as an incentive for banks to boost their lending activity. The amendment envisaged additional reduction of the FX reserve requirement ratios by one percentage point – to 26% on liabilities with maturity up to two years and to 19% on liabilities with maturity over two years. At the same time, the share of dinar allocations of FX required reserves was increased by two percentage points – to 38% and 30%, depending on the maturity of the sources of funding. With this measure, the NBS continued the cycle of cuts in the FX reserve requirement ratios initiated in November 2014.

In September 2015, the NBS amended the Decision again, aiming at further monetary policy easing. In line with the commitment to approach policy-easing with caution, it was decided that, while keeping ratios differentiated by maturity of funding, the FX reserve requirement ratios on sources with the maturity of up to and over two years (26% and 19%, respectively) would be cut by one percentage point in each of the next six maintenance periods – to 20% and 13%, respectively as of the 2016 February maintenance period.

To discourage further increase in banks' FX-indexed dinar liabilities which could generate depreciation pressures, a special FX reserve requirement of 50% was introduced in June 2012 and applied to the portion of the foreign currency base composed of FX-indexed liabilities. In December 2015, this ratio was raised from 50% to 100% with the aim to curb further FX-indexation of dinar liabilities and to stimulate market participants to rely more on standardised risk protection measures.

Despite an increase in the dinar reserve base, in 2015 the calculated required reserves allocated in dinars were lower by RSD 12.8 bln than a year earlier and came at RSD 145.3 bln. This was due to the reduction in FX required reserve allocations in dinars resulting from the above regulatory amendments. The amount of calculated required reserves allocated in foreign currency was lower by EUR 374.9 mln and came at EUR 1.6 bln at end-2015, due to the above reduction in FX reserve requirement ratios.

Foreign exchange market operations

Under the 2015 Monetary Policy Programme, the NBS continued implementing the managed floating exchange rate regime. Its interventions in the foreign exchange market aimed to ease excessive short-term volatility of the exchange rate, to safeguard financial stability and to maintain an adequate level of foreign exchange reserves.

In nominal terms, the dinar lost 0.5% against the euro in 2015. The NBS intervened in the IFEM as a net buyer of EUR 520.0 mln, purchasing EUR 970.0 mln and selling EUR 450.0 mln. The NBS intervened as a price taker, strictly under market conditions.

The dinar's depreciation against the euro (2.1%) in January was primarily a consequence of seasonally higher FX demand of domestic energy importers. However, positive expectations of market participants regarding the signing of the precautionary stand-by arrangement with the IMF, as a guarantee of further implementation of fiscal consolidation measures and structural reforms, sparked investors' interest in longer maturity government securities, which led to the strengthening of the dinar vis-à-vis the euro in February and March by 2.7% and 0.1%, respectively. In nominal terms, the dinar gained 0.6% against the euro in Q1, while the NBS intervened by net buying EUR 170.0 mln (purchasing EUR 260.0 mln and selling EUR 90.0 mln).

A relatively steady movement of the dinar exchange rate in Q2 (depreciation of 0.3% in nominal terms) was primarily due to the improved macroeconomic and fiscal prospects of the country. Higher demand of banks' clients for foreign exchange was almost entirely covered by the higher inflow of remittances (purchase of foreign cash from exchange dealers and natural persons), which considerably reduced depreciation pressures. Additional stability in the FX market was provided by banks which sold foreign exchange after approving FX-indexed loans, in order to balance their FX positions. In Q2, the NBS intervened in the FX market by net purchasing EUR 120.0 mln (purchasing EUR 150.0 mln and selling EUR 30.0 mln). Similar trends lasted into H2, until mid-October. In Q3, the dinar gained 0.7% vis-à-vis the euro in nominal terms, and the NBS net purchased EUR 440.0 mln (purchasing EUR 450.0 mln and selling EUR 10.0 mln). Positive macroeconomic indicators and the success of fiscal consolidation measures were confirmed by the positive review of the arrangement with the IMF.

Depreciation pressures prevailed in the closing quarter of 2015 (chiefly as a result of higher uncertainty in international markets sparked by the drop in oil prices and Fed's increase in the target range for the federal funds rate). Since the second half of October, non-residents' demand for foreign exchange intensified, followed by the sale of dinar government securities in the secondary market. Depreciation pressures were somewhat mitigated through a more intense purchase of cash from exchange dealers and natural persons. The dinar came under strong downward pressures in December, as a consequence of increased sale of foreign exchange to domestic companies and energy importers and elevated demand of foreign investors amid expectations for the Fed to raise its benchmark rate in its December meeting. In December alone, the NBS net sold EUR 270.0 mln in the IFEM, as compared to EUR 210.0 mln at the level of the quarter as a whole.

Foreign exchange swaps

In 2015, the NBS continued to hold its regular three-month and two-week foreign exchange swap auctions to promote interbank swap trading and facilitate more efficient bank liquidity management. Three-month FX swaps were organised on a weekly basis and under market conditions to auction predetermined amounts of liquidity. Two-week FX swap auctions, as additional support to banking system liquidity management, were also held once a week, under market conditions but without predetermining the amount of foreign exchange to be sold/purchased in the auction.

In 2015, the NBS held 102 three-month and 98 two-week FX swap auctions, buying/selling EUR 75.0 mln and EUR 437.5 mln, respectively. On 6 July, the NBS held extraordinary FX swap auctions, with 28-day maturity, at which its swap sold/bought EUR 38.0 mln. At the end of 2015, NBS receivables and liabilities under three-month swaps equalled EUR 26.0 mln each, while those under two-week swaps equalled EUR 31.0 mln each.

Other interest rates

The Decision on Interest Rates Applied by the National Bank of Serbia in the Implementation of Monetary Policy was amended four times in the course of 2015.

Amid cuts in the key policy rate and with the aim of reducing the possibility of considerable fluctuations of interest rates in the interbank money market, in May 2015, the interest rate corridor (lending and deposit facility rates) was narrowed relative to the key policy rate from ±2.5 pp to ±2.0 pp.

To implement the Decision on Terms and Manner of Granting Emergency Liquidity Assistance Loans to Banks in cases when a bank defaults on a loan, and to harmonise the NBS regulation with the Law on Default Interest Rate, the Decision on Interest Rates Applied by the National Bank of Serbia in the Implementation of Monetary Policy was amended again in July 2015. Under this amendment, the NBS charges interest on loans not repaid within the stipulated deadline – applying the interest rate envisaged under the said law.

Also, interest rate on the shortfall of the allocated/calculated dinar required reserves (key policy rate plus 5 percentage points) was made equal to the rate on emergency liquidity assistance loans in dinars which are the most expensive type of central bank loans to banks.

Analogously with the above, interest rate on the shortfall of the allocated/calculated FX required reserves (three-month EURIBOR plus 5 percentage points) was made equal to the rate on emergency liquidity assistance loans in FX.

In addition to the above changes, the Decision was amended on another two occasions in 2015 – in October and November, whereby interest paid by the NBS on the average daily balance of allocated dinar required reserves was first cut from 2.50% to 2.00%, and then to 1.75% per year.

3 Achievement of inflation target in 2015

Inflationary pressures remained muted in 2015 as well, reflecting majority of domestic factors, low prices of primary commodities in the world market (oil and primary agricultural commodities) and, generally, subdued inflation in the international environment

Owing primarily to a sizeable fall in prices of oil and primary agricultural commodities in the global market, y-o-y inflation in Serbia, like in many other European countries, continued to run low and measured 1.5% in December. Average y-o-y inflation rate in 2015 came at 1.4%.[2]

Observed aggregately, food prices stagnated in 2015. Though prices of processed food rose to some extent, the increase was offset by the fall in unprocessed food prices, in place since mid-2015. Overall in 2015, **prices of unprocessed food** dropped by 4.5%, knocking 0.5 pp off the inflation rate. Growth in **processed food prices**, though somewhat accelerated, remained low (2.5% y-o-y in December, 0.5 pp contribution to inflation), owing to persistently low prices of primary agricultural commodities (primarily wheat and corn) in the global and domestic markets. The strongest positive contribution came from the prices of non-alcoholic beverages, sugar and confectionery, while the prices of milk, dairy and meat products provided the largest negative contribution.

Prices of industrial products excluding food and energy inched up by 3.0% in 2015 (adding 0.9 pp to inflation). H1 witnessed their y-o-y fall, while mid-year saw a reversal of the trend. The reversal was driven mainly by the prices of cigarettes, which were increased three times during 2015 (in April, July and December), partly due to the correction of the minimum excise and in

Table II.3.1 **Growth and contribution of components to consumer price growth in 2015**

	Growth rates (%)	Contribution (pp)
Consumer prices (CPI)	**1.5**	**1.5**
Unprocessed food	-4.5	-0.5
Processed food	2.5	0.5
Industrial products excluding food and energy	3.0	0.9
Energy	1.5	0.2
Services	2.0	0.5
Core inflation indicators		
CPI excluding energy	1.5	1.3
CPI excluding energy and unprocessed food	2.6	1.9
CPI excluding energy, food, alcohol and cigarettes	1.6	0.7
Administered prices	5.5	1.1

Sources: SORS and NBS calculation.

[2] According to the estimate of the Serbian Statistical Office, the average annual rate of inflation in 2015 was somewhat higher, measuring 1.9%.

part also because of the producer's business decision. Therefore, despite a y-o-y fall of 8.0% recorded in January, prices of cigarettes ended the year with a y-o-y growth 12.9%, while their contribution to y-o-y inflation increased from -0.4 pp to +0.6 pp. Relative stability of the dinar exchange rate and low domestic demand ensured a moderate level of growth of prices of other products in this group.

Service prices grew by 2.0% on the annual basis (0.5 pp contribution to inflation), chiefly driven by a rise in prices of travel arrangements and mobile telephony.

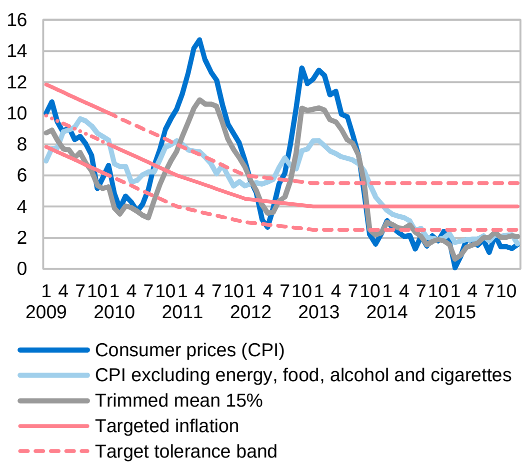
Energy prices inched up by 1.5% (0.2 pp contribution to inflation). The increase was driven by a 12.2% rise in electricity prices from August (0.6 pp contribution to inflation), while prices of petroleum products and natural gas, reflecting the fall of oil prices in the global market, worked in the opposite direction. Thus, the domestic market saw the cheapening of petroleum products by 5.8% (-0.3 pp contribution to inflation), and of natural gas by 15% (-0.1 pp contribution to inflation).

Administered prices, i.e. those that are directly or indirectly government-controlled, grew by 5.5% in 2015 (1.1 pp contribution to inflation). In y-o-y terms, they declined from January to July, and picked up from August, reflecting the increase in electricity prices. Prices of cigarettes contributed equally (0.6 pp), while the prices of medicaments and natural gas worked in the opposite direction.

Core inflation[3], the part of CPI under the strongest influence of monetary policy measures, continued to move below the lower bound of the target tolerance band in 2015 as well, measuring 1.6% in y-o-y terms in December (0.7 pp contribution to y-o-y inflation). Such movement of core inflation may be associated with the relatively stable exchange rate of the dinar, low aggregate demand and low inflation in the international environment. The greatest positive impetus to core inflation came from the prices of travel arrangements and mobile telephony services, while prices of medicaments exerted the strongest downward pressure.

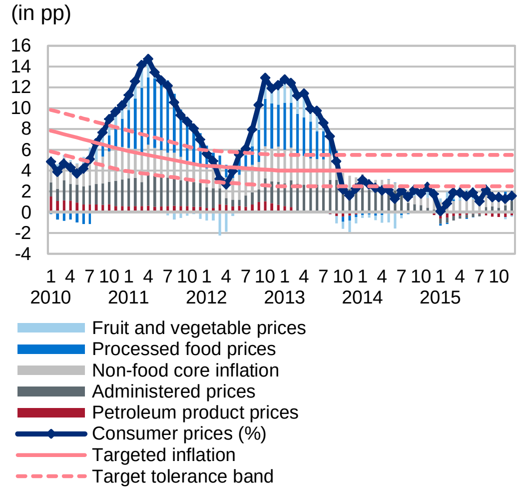
As y-o-y inflation continued to move below the target tolerance band, the NBS wrote a letter to the Government in March and September 2015 in which it explained the reasons for inflation's departure from the target, outlined the measures that were taken and that need to be taken to bring inflation within the target band in the medium run and stated its expectations as to when the inflation would return within the band.[4] Namely, according to the Agreement between the National Bank of Serbia and the Government of the Republic of Serbia on Inflation Targeting, the NBS sends a letter to the Government when inflation departs from the set target for longer than six consecutive months.

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



Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

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

[4] See Appendixes 1 and 2.

III Macroeconomic environment

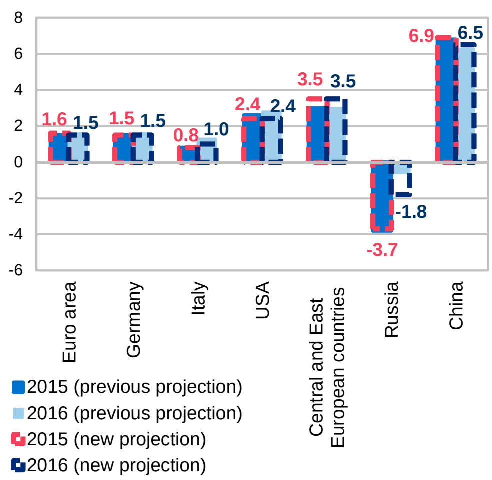
1 International environment

The recovery in **euro area** activity begun in late 2014 continued into 2015 and the region's real GDP expanded by 1.6% at annual level. Driven primarily by external demand sustained by the euro's weakening vis-à-vis major world currencies, the growth was somewhat stronger in H1 (0.6% s-a in Q1 and 0.4% s-a in Q2). In H2, GDP growth lost some steam (0.3% s-a in each quarter), as the contribution from external demand lessened amid a slowdown across emerging economies. The chief driver of growth during that period was domestic demand, mainly final household consumption which, throughout the entire year, felt the positive effects of higher disposable income sparked by a drop in oil prices and an improvement in the labour market conditions.[5] A positive contribution also came from private investment which benefited from lower borrowing costs due to the ECB's accommodative policy stance. In 2015, GDP expanded in the entire euro area, except for Greece. What matters for Serbia, is that its main foreign trade partner, Italy, emerged from the three-year recession (growth of 0.8% in 2015).

Having been negative in the first months of 2015, euro area inflation entered the positive zone in May (0.3% y-o-y), yet came weaker than expected by the end of the year and treaded near zero (0.1%-0.2% y-o-y). The prime reason for low inflation was the massive drop in world oil prices. Inflation was expected to pick up late in the year, primarily owing to the base effect i.e. a drop in oil prices in late 2014 (yet it was absent due to a new drop in oil prices from the already low level) and a slight rise in prices of food and services.

The recovery of euro area economic growth spilled over to the **Central and Eastern Europe**, whose GDP growth in 2015 slightly accelerated to 3.5%. The countries of Central Europe, whose economies are most closely linked to the euro area and which made the most of the positive effects of the ECB's monetary relaxation, maintained relatively brisk pace of growth, while GDP growth in

Chart III.1.1 **Revisions of real GDP growth forecasts for 2015 and 2016 by the IMF**
(in %)



Sources: IMF WEO (October 2015) and IMF WEO April 2016).

[5] In 2015, unemployment rate slid by 1.0 pp, coming at 10.4% in December.

Southeast Europe went at a somewhat slower rate. On the other hand, a drop in oil prices and economic sanctions pulled down Russia's GDP, which reflected in a slowdown across Baltic countries.

Inflation rates stayed low or negative in most Central and Eastern Europe countries in 2015, due to lower prices of oil but also of food which carries a significant weight in the consumer price index in these countries. Bulgaria, which has been facing deflation for two and a half years, recorded negative inflation rates. Inflation was also negative throughout the year in Bosnia and Herzegovina, and in the latter half of the year in Romania, Macedonia and Croatia. Disinflationary pressures were felt in Hungary and Montenegro, albeit to a lesser extent. On the other hand, Russia and Turkey were regional exceptions, witnessing significant depreciation of their currencies and consequently high inflation.

In 2015, economic growth in the **USA** kept the pace recorded a year earlier (2.4%). Household consumption was the main fillip to GDP growth, largely owing to improved conditions in the labour market. Unemployment rate stayed on the downward trajectory for the seventh consecutive year, dropping to 5.0% in December 2015, while new job gains in the non-agricultural sector kept the relatively high average level of 230 thousand per month. Moreover, drop in oil prices, low inflation, a rise in real estate prices and stock exchange indices contributed to the increase in real disposable household income and a rise in consumer confidence index. On the other hand, dollar's gain against major world currencies, and global economic slowdown affected net exports which contributed negatively to the GDP trend. A drop in oil prices amid falling import prices on account of the dollar's appreciation, created disinflationary pressures in the USA throughout the year. The y-o-y inflation moved below or close to 0% for the better part of H1 and returned to the positive zone in June (0.1%). Although increasing gradually throughout the year (0.7% y-o-y in December), it still ran below its long-run objective of 2%. According to the Fed's expectations, inflation will stay low in the short run, but will climb to the 2% objective in the medium run, as the effects of falling oil prices dissipate and labour market conditions strengthen further.

China's adjustment to the new growth model led to a slowdown in its GDP growth to 6.9% in 2015, its lowest level in the last 25 years. On the expenditure side, GDP growth was driven by final consumption and was propelled by the services sector from the production side, while investment, although positive, made a weaker contribution than a year earlier. Signals of China's slowdown were detected during the summer, causing instabilities in Chinese stock exchanges and capital outflow, as well as downward pressures on the currency and the reduction in FX reserves. China's slowdown in the second half of the year was among major factors that gave rise to growing uncertainty in the international financial market, volatility in stock exchanges around the world, and a drop in prices across international markets for primary products, which put a drag on global economic growth via trade and financial channels.

Monetary policies implemented by central banks of the developed countries stayed accommodative in 2015, which, coupled with a drop in global oil prices, facilitated economic recovery. In order to fight sluggish economic growth and low inflation, the ECB pursued increasingly accommodative monetary policy throughout the year. In March, the ECB started its public sector purchase programme, while continuing previously initiated asset-backed securities purchase programme and cover bond purchase programme. These programmes envisage monthly purchase of securities in the amount of EUR 60 bln which should inject around EUR 1,100 bln of additional liquidity by end-September 2016 i.e. the planned deadline for their completion. Recognising that numerous measures fell short of expectations, particularly in regard to higher inflation, in December the ECB adopted new measures: it decreased the interest rate on the deposit facility to -0.3% and extended its QE programme until March 2017. New measures were

Table III.1.1 **Economic growth forecasts by country**
(in %)

	Consensus Forecast January 2016		IMF April 2016	
	2015	2016	2015	2016
Poland	3.5	3.5	3.6	3.6
Czech Republic	4.5	2.6	4.2	2.6
Hungary	2.7	2.3	2.9	2.3
Albania	2.7	3.3	2.6	3.4
Bulgaria	2.8	2.6	3.0	2.3
Bosnia and Herzegovina	2.7	2.9	2.8	3.0
Macedonia	3.3	3.8	3.7	3.6
Montenegro	-	-	4.1	4.7
Romania	3.7	4.0	3.7	4.2
Slovenia	2.6	2.1	2.9	1.9
Croatia	1.6	1.5	1.6	1.9

Sources: Consensus Forecast and IMF.

adopted amidst low oil prices and China's slowdown and consequently weaker prospects of global growth. These conditions also made the **Fed** delay until December its decision to start the monetary policy normalisation. The target range for the federal funds rate was increased by 0.25% for the first time since 2006 and the rate now moves within the 0.25%-0.50% range. The decision to increase the target range was primarily shaped by favourable data from the labour market, particularly data on ongoing job gains, which significantly exceeded all expectations. It was underscored that possible tightening would be gradual and moderate, i.e. that there would be a shift from the most extreme accommodative policy on record towards a moderately accommodative monetary policy.

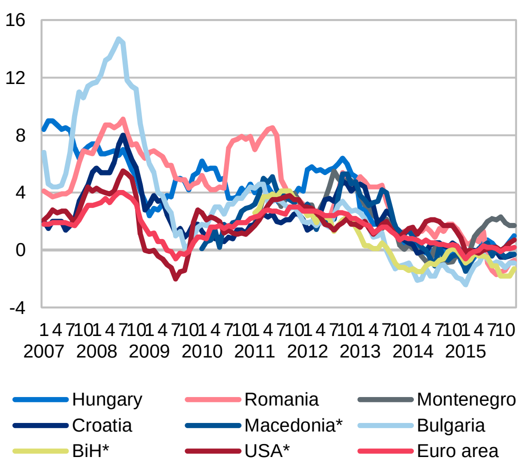
Owing to low oil prices, globally low inflation, the increasingly accommodative policy of the ECB and the Fed's decision to postpone increasing the federal funds rate, monetary policies of central banks in **Central and Eastern Europe** were also accommodative in 2015. The policy rate was reduced in most countries in the first half of the year, and in most cases kept unchanged in the latter half. At the end of the year, the policy rate was 1.0 pp lower in Romania, 0.75 pp in Hungary and Turkey and 0.5 in Poland. Russia witnessed the sharpest cut in the policy rate in 2015 (by 5.0 pp to 11.0%), which was raised by 9 pp to 17.00% in December 2014 because of a heavy drop in global oil prices and problems caused by limited access of Russian companies to the international capital market (due to sanctions imposed by Western countries), which caused the rouble to plummet.

Diverging monetary policies pursued by the ECB and the Fed reflected on **trends in foreign exchange markets**, pushing the euro down vis-à-vis the dollar. The euro was also driven down by the Greek crisis. Observed at period end, in 2015 the euro lost 10.1% against the dollar, dipping in mid-March, mid-April and in early December to its lowest level since 2003.

Currency markets were stunned in January by the Swiss National Bank's decision to remove the exchange rate peg of 1.20 Swiss francs to the euro. In making this decision, the Swiss National Bank was guided by the assessment that, since the ceiling was introduced in September 2011, overvaluation of the franc had in the meantime decreased and that the economy was now capable of adjusting to the current market conditions. This decision caused the franc's appreciation, which rose from the minimum level to less than one franc per euro, quickly stabilising thereafter and treading at around 1.04-1.09 CHF/EUR range for the rest of the year. Such trends affected credit markets of some Central and Eastern Europe countries where a part of banks' portfolios was denominated in francs, as the franc's appreciation made loan servicing more costly.

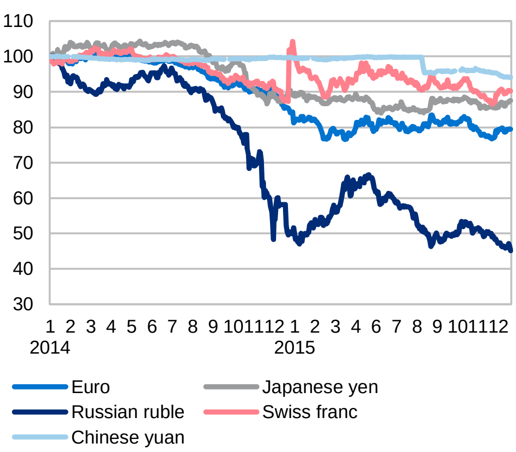
Measured by the FAO Index, **global food prices** declined by 18.9% in 2015, in real terms, going further down for

Chart III.1.2 **HICP across selected countries**
(y-o-y rates, in %)



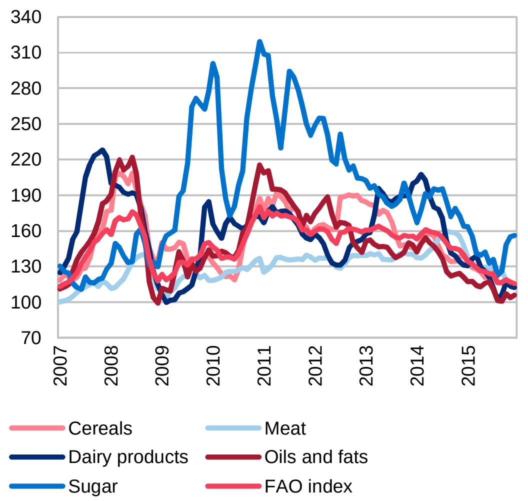
Sources: Eurostat, Bureau of Labor Statistics and statistical offices of selected countries.
* CPI.

Chart III.1.3 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



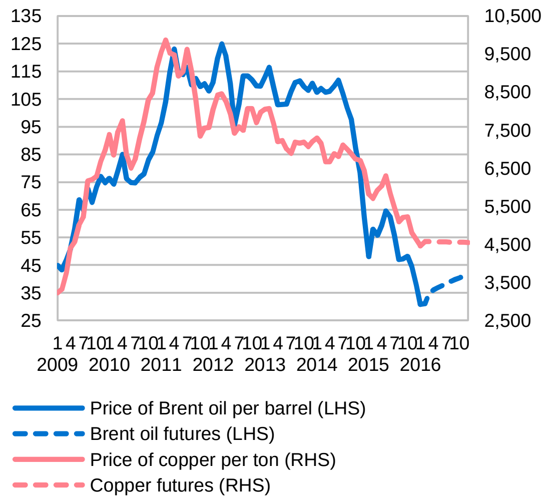
Source: IMF database.
* Growth indicates appreciation.

Chart III.1.4 **World food price index**
(in real terms, 2002–2004 = 100)



Source: FAO, UN.

Chart III.1.5 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

the fourth consecutive year. A modest global demand amidst heavy supply and the US dollar strengthening came again as the main reason for low food prices in 2015. Prices of all food products plummeted in real terms from 2014. Dairy prices lost the most (28.7%), followed by prices of sugar (21.2%), vegetable oil (19.1%), crops (15.6%) and meat (15.3%).

World **Brent oil prices** went further down in 2015, and having lost 35.9% from end-2014, they dropped to USD 35 per barrel at year-end. Even the average 2015 price of USD 52 per barrel was significantly lower compared to the USD 99 per barrel in 2014. Key factors of plummeting world oil prices can be found on both the demand and supply side: slower than expected global growth, record high global oil inventories and excessive supply due to the unwillingness of OPEC member countries to cut back production.

The **price of copper**, the metal whose widespread use ranges from the automobile industry to electric power transmission, did not recover in 2015 either. For most of the year it moved below USD 6,000 per tonne but dropped below USD 5,000 per tonne at the end of the year. Copper prices were dragged down by the strengthening of the dollar and economic slowdown of China, the world's largest consumer and importer of this raw material.

Instability across financial markets at the beginning of the year pushed the **price of gold** up, but demand for gold soon dropped due to the dollar's appreciation and expected U-turn in the Fed's monetary policy, which directed investors towards higher yield assets. In annual terms, the price of gold fell by 12.1%.

2 International transactions

Balance of payments and FX reserves

External imbalances narrowed further in 2015, owing largely to the implementation of fiscal consolidation and structural reforms, falling global oil prices and the gradual recovery of external demand. The current account deficit was lower by a fifth and was fully covered by FDIs. In contrast to 2014, thanks to a more robust FDI inflow and lower net foreign debt repayment under **financial loans**, the capital and financial account showed a net capital inflow, thus boosting NBS FX reserves.

According to preliminary data[6], the **current account** deficit of EUR 1,577.4 mln (4.8% of GDP) in 2015 was lower by EUR 407.3 mln compared to 2014. The current account structure improved as the deficit on the trade in goods declined, whereas the surplus on the trade in services and the surplus on the secondary income account

[6] In accordance with BPM6.

widened. Expectedly, it was only the deficit on the primary income account that went up.

Consistent implementation of fiscal consolidation and structural reforms, falling global oil prices and the gradual economic recovery of our main foreign trade partners (EU and CEFTA countries) had a positive impact on the **deficit on the trade in goods**, which stood at EUR 3,993.4 mln, down by EUR 117.3 mln relative to 2014. **Exports** expanded 6.7% y-o-y, led mainly by a rebound in exports in the manufacturing sector (base metals, metal products, other machinery and equipment, and tobacco products) and agricultural products, mainly fruits and vegetables. In contrast, exports contracted in the oil industry as lower prices of petroleum products resulted in a lower value of exports of this group of products, including the automobile industry. At the same time, the steel plant Smederevo restored production and stepped up exports relative to the previous year.

Imports of goods were up 4.1% in 2015. The sharpest increase was observed for machinery, telecommunications equipment and metal ores. Conversely, tumbling global oil prices pushed up imports of oil and petroleum products worth almost EUR 300 mln less compared to 2014. The situation was similar with gas imports. Owing to a sharper rise in exports than imports, the import-export ratio rose from 72.1% in 2014 to 74.0% in 2015.

The surplus on the **services account** was up EUR 260.1 mln in 2015, as a result of a sharper rise in exports than imports. Exports of services increased (by EUR 463.8 mln) in almost all categories, most notably in transportation, computer services, other business and travel services. Imports of services rose EUR 203.7 mln – mostly those relating to travel, transportation and other business services. Both exports and imports of construction services declined from 2014.

The **deficit on the primary income account** widened to EUR 1,658.0 mln. Net expenditure rose by EUR 247.6 mln in respect of FDI receipts, and by EUR 112.9 mln in respect of portfolio investment income. Income from other investment was also negative, though less by EUR 18.6 mln compared to 2014. Owing to adequate management and cross-currency trends in the global financial market, 2015 saw a further increase in income from FX reserves by EUR 17.2 mln relative to 2014.

The surplus on the **secondary income account** widened by EUR 345.3 mln, reflecting primarily a rise in remittances by EUR 228.8 mln to EUR 2,671.1 mln. Thus, their share in GDP rose from 7.2% in 2014 to 8.1% in 2015. The surplus on the secondary income account increased also owing to a rise in government current transfers (by EUR 72.1 mln), helped by elevated official aid inflows. The rise in the surplus on the secondary income account improved the coverage of the deficit on goods and services and the deficit on the primary income account by 7.6 pp to 67.8%.

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

	2014	2015
I CURRENT ACCOUNT	-1,984.7	-1,577.4
1. Goods	-4,110.7	-3,993.4
1.1. Credit	10,641.0	11,357.1
1.2. Debit	14,751.7	15,350.5
2. Services	465.3	725.4
2.1. Credit	3,809.6	4,273.5
2.2. Debit	3,344.4	3,548.1
3.Goods and services	-3,645.4	-3,268.0
3.1. Credit	14,450.7	15,630.6
3.2. Debit	18,096.1	18,898.6
4. Primary income	-1,342.6	-1,658.0
4.1. Credit	642.3	682.1
4.2. Debit	1,984.9	2,340.1
of which: interest	907.6	1,010.3
5. Secondary income	3,003.3	3,348.6
5.1. Credit	3,399.8	3,794.5
5.2.Debit	396.6	445.9
II CAPITAL ACCOUNT	6.5	-17.5
III FINANCIAL ACCOUNT (excluding reserve assets)	91.6	-1,371.4
1. Direct investment, net	-1,236.3	-1,803.8
1.1. Net acquisition of financial assets	264.2	310.4
1.2. Net incurrence of liabilities	1,500.5	2,114.2
2. Portfolio investment, net	-368.9	289.2
2.1. Net acquisition of financial assets	72.9	76.8
2.2. Net incurrence of liabilities	441.7	-212.5
3. Financial derivates, net	-6.0	1.9
3.1. Net acquisition of financial assets	-5.8	1.9
3.2. Net incurrence of liabilities	0.2	0.0
4. Other investment, net	1,702.8	141.3
4.1. Trade credit and advances, net	116.4	128.8
4.1.1. Net acquisition of financial assets	436.5	464.3
4.1.2. Net incurrence of liabilities	320.1	335.5
4.2. Financial loans, net	756.7	230.4
4.2.1. Net acquisition of financial assets	-33.5	32.2
4.2.1.1. Long-term	-36.0	17.8
4.2.1.2. Short-term	2.5	14.3
4.2.2. Net incurrence of liabilities	-790.2	-198.2
4.2.2.1. Long-term	-687.8	-375.9
4.2.2.2. Short-term	-102.4	177.7
4.3.Currency and deposits, net	829.7	-217.9
4.3.1. Net acquisition of financial assets	935.2	-189.0
4.3.2. Net incurrence of liabilities	105.5	28.9
IV Reserve assets	-1,796.7	166.5
V NET ERRORS AND OMISSIONS	273.1	390.0
VI OVERALL BALANCE	1,796.7	-166.5

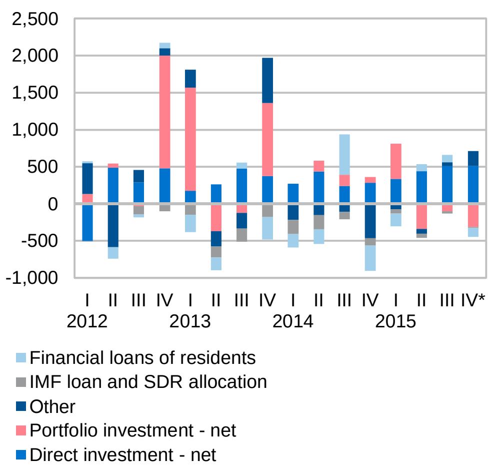
Sources: SORS and NBS.
Note: Preliminary data.
[1)] BPM6 methodology.

The **capital and financial account** (excluding changes in FX reserves) saw a net capital inflow of EUR 1,353.9 mln or 4.1% of GDP in 2015. Improved macroeconomic conditions and the business ambience led to a much higher **FDI** inflow. FDIs rose to EUR 1,803.8 net, up by EUR 567.5 mln (around 46%) from 2014. Most FDIs were channelled to manufacturing, financial activities, construction and trade. Within manufacturing, investments in the production of rubber and plastic, motor vehicles, food products, chemical products and textile were the most notable. Importantly, FDI flows are diversified across projects, supporting the sustainability of economic growth in the coming period. Total 86.0% of FDIs came from European economies – 72.4% from the EU, 5.7% from the United Arab Emirates, 4.6% from the Russian Federation, and 4.5% from Switzerland.

Awaiting the decision on the Fed's rate hike, foreign investors were reducing their exposure to emerging economies in 2015, including Serbia. Following the net **portfolio investment** inflow in 2014 (EUR 368.9 mln), 2015 saw a net outflow of EUR 289.2 mln.

In 2015, net foreign debt repayment under **financial loans** declined to almost a fourth of that in 2014 and reached EUR 198.2 mln. All sectors other than the government cut back on their net external credit liabilities – the NBS by EUR 153.4 mln, banks by EUR 401.8 mln, and enterprises by EUR 107.2 mln. The government raised its net credit liabilities by EUR 464.2 mln.

Chart III.2.1 **Structure of the financial account**
(EUR mln)



Sources: SORS and NBS.
* Preliminary data.

Unlike the year before, **resident deposits abroad** declined (EUR 189.0 mln) and non-resident deposits with domestic banks went up (EUR 28.9 mln), while as in 2014 an outflow was recorded under **trade loans** (EUR 128.8 mln).

Balance of payments movements in 2015 resulted in a EUR 166.5 mln increase in FX reserves (excluding cross-currency changes, changes in the market value of securities and the price of gold).

As at 31 December 2015, NBS FX reserves stood at EUR 10,378.0 mln, up by EUR 470.8 mln from end-2014. The net effect of FX transactions was positive at EUR 166.5 mln, as were net market effects (cross-currency changes, changes in the price of gold and market value of securities) at EUR 304.3 mln. At the same time, net FX reserves stood at EUR 8,420.0 mln, up by EUR 763.0 mln compared to end-2014.

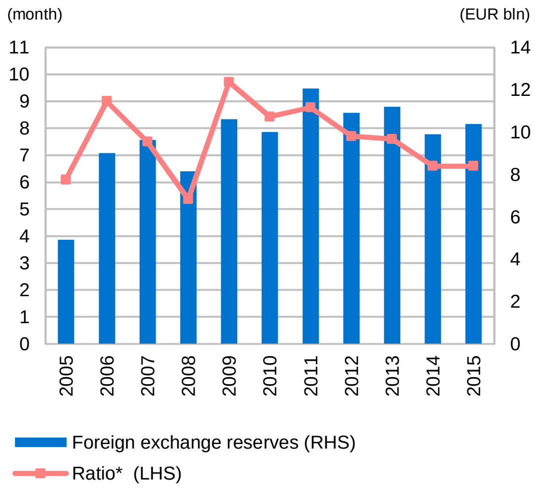
On 31 December 2015, NBS FX reserves covered money supply (M1) by 250% and around seven months of imports of goods and services.

At end-2015, foreign securities accounted for the largest portion of FX reserves (66.7%), followed by FX balances in accounts abroad (22.1%), gold (5.5%), foreign cash (5.6%) and SDR (0.1%). **Consistent with the primary principles of safety and liquidity, funds are invested with top-tier institutions (central banks, international financial institutions and prime foreign banks) and in highly liquid securities issued by the most advanced countries in the world and international financial institutions**.

The FX inflow from the sale of euro-denominated RS securities in the domestic financial market came at EUR 1,006.6 mln in 2015. Inflows also originated from the disbursement of loans extended to the Republic of Serbia (EUR 493.6 mln), NBS interventions in the IFEM (EUR 425.0 mln net)[7], temporary payment transactions with

[7] 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.

Chart III.2.2 **Ratio of FX reserves to imports**



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

Kosovo and Metohija[8] (EUR 389.6 mln), grants (EUR 203.7 mln), privatisation (EUR 19.7 mln), investment in foreign securities and collection of interest on FX deposits (EUR 59.0 mln).

In 2015, liabilities to foreign creditors were settled in time (EUR 1,076.2 mln) in respect of both the principal and interest. The redemption of RS euro-denominated securities at maturity accounted for an outflow of EUR 684.2 mln. The servicing of frozen FX savings dragged FX reserves down by EUR 276.0 mln. The outflow on account of banks' withdrawal of FX required reserves came at EUR 273.8 mln net. Total EUR 146.9 mln were drawn down to cover the repayment of interest and principal on debts to the IMF, and EUR 57.9 mln for the repayment of government debt to domestic banks.

International investment position

Serbia's international investment position of a net debtor increased in 2015 by EUR 1.9 bln to EUR 34.6 bln at the year-end or 105.3% of estimated GDP.

Net external financial assets were up EUR 1.2 bln from 2014 to EUR 19.4 bln at end-2015, on account of transactions (EUR 858.5 mln) and cross-currency changes (EUR 363.1 mln). Changes in prices and other changes worked towards their reduction (EUR 57.9 mln and EUR 5.4 mln respectively). Within net financial assets, a considerable rise was observed for FX reserves, which made up more than a half of total assets, as well as direct investments and other resident investments abroad – due to an increase in trade loans and advances.

Resident direct investments abroad rose by EUR 312.4 mln in 2015. As a result, receivables from such investments amounted to EUR 2.7 bln at the year-end, accounting for 13.7% of total assets, which is 0.9 pp more compared to end-2014.

Resident portfolio investments abroad continued up, though still making up a small portion of total assets (1.0%). At end-2015, foreign securities owned by Serbian investors were worth EUR 199.6 mln.

Other investments grew by EUR 297.3 mln to EUR 6.2 bln (31.8% of total assets) – on the back of a EUR 464.3 mln rise in trade loans and advances (to EUR 1.3 bln), while cash and deposits fell by EUR 189.0 mln (to EUR 4.7 bln). Banks reduced their holdings of cash and deposits abroad, while they were raised by other sectors.

Net external financial liabilities expanded by EUR 3.0 bln to EUR 54.1 bln in 2015 – on account of net transactions worth EUR 2.1 bln and cross-currency changes in the amount of EUR 964.0 mln. Price changes prompted an increase in net financial liabilities, and other changes led to their reduction (EUR 6.9 mln and EUR 28.3 mln respectively).

FDIs were the primary factor behind the increase in net financial liabilities. In 2015, liabilities under FDIs climbed by EUR 2.1 bln to EUR 26.5 bln, making up 49.0% of total liabilities. The growth was driven primarily by foreign investments in equity capital (EUR 1.9 bln) – the stock amounted to EUR 20.2 bln at end-2015 (37.5% of total liabilities), while the stock under debt instruments reached EUR 6.2 bln (11.6% of total liabilities).

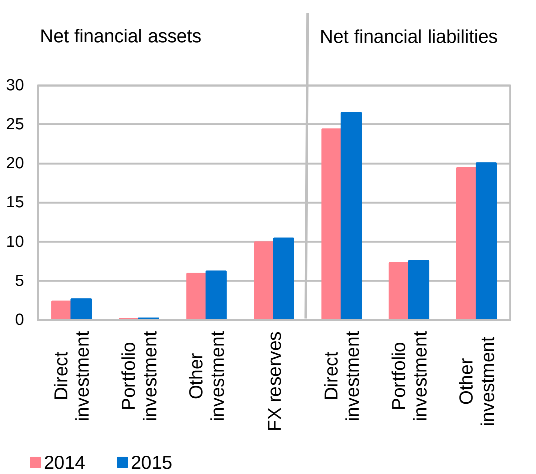
[8] Under the Law on Temporary Execution of Certain Payment Operations in the Federal Republic of Yugoslavia (FRY Official Gazette, No 9/01).

Owing to significant cross-currency changes in the international financial market, resident liabilities (notably of the government) under portfolio investments rose by EUR 281.0 mln, but declined in respect of transactions (EUR 212.5 mln). At end-2015, portfolio investments amounted to EUR 7.6 bln, constituting 14.0% of total liabilities.

Within financial liabilities, resident liabilities under other investments came at EUR 20.0 bln at end-2015, making up 37.0% of total liabilities. Relative to end-2014, other investments were up EUR 610.7 mln. Almost three fourths of the increase was due to cross-currency changes, and the rest to net transactions. Cross-currency changes drove up liabilities under financial loans, notably of the government (EUR 341.9 mln), which raised them by EUR 464.2 mln in respect of transactions. As a result, government debt under financial loans rose to EUR 9.7 bln. Through debt repayment to the IMF, the central bank reduced its liabilities under financial loans to EUR 62.3 mln. Banks and enterprises also repaid their debt – at end-2015 their liabilities stood at EUR 2.2 bln and EUR 5.0 bln respectively.

Within other investments, trade loans and advances moved up – at end-2015, their stock stood at EUR 1.5 bln, or 2.8% of total liabilities. Cash and deposits increased less – to EUR 878.7 mln.

Chart III.2.3 **International investment position***
(EUR bln)



Source: NBS.
* Preliminary data.

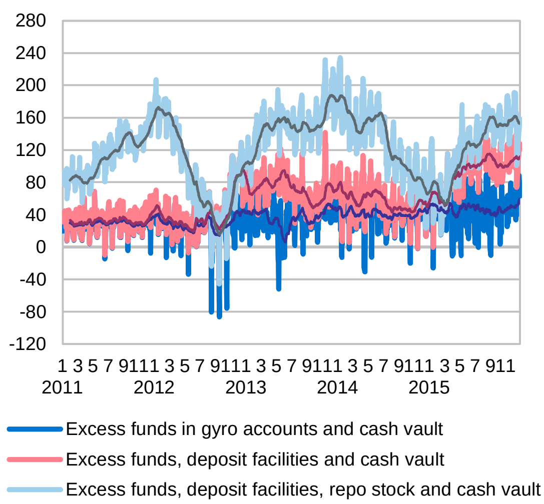
3 Financial market

Interest rates

At end-December 2015, the average repo rate[9] came at 2.6%, declining by 3.6 pp relative to end-2014, i.e. slightly more than the key policy rate (by 3.5 pp) in 2015. In addition, due to temporary shrinking of excess dinar liquidity of banks, auctions were not organised from 18 February until the beginning of April. Thus, the first repo auction held after the recess reflected also the March cut-down in the key policy rate. For the remainder of the year, as banks' dinar liquidity bounced back, the average repo rate was almost equal to the deposit facility rate.

Trading volumes in the interbank overnight money market in 2015 averaged RSD 3.6 bln, rising by RSD 1.1 bln from the year before, and peaking during Q1. BEONIA reflected changes in bank liquidity, so after the February increase it followed a downward path until end-H1. In July and August this rate fluctuated more strongly, mirroring market reactions to the escalation of the Greek crisis. Reaching of an agreement with creditors soothed the uncertainties in late August and BEONIA again came close to the deposit facility rate and continued to trend in its vicinity for the rest of the year. In December, BEONIA averaged 2.6%, down by 4.9 pp y-o-y.

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



Source: NBS.

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

BELIBOR rates mirrored BEONIA movement in early 2015 – they fell in January, inched up in February and continuously declined from March until year-end. In December, these rates averaged between 3.1% for the shortest and 4.1% for six-month maturity, down between 4.7 pp and 4.9 pp relative to December 2014.

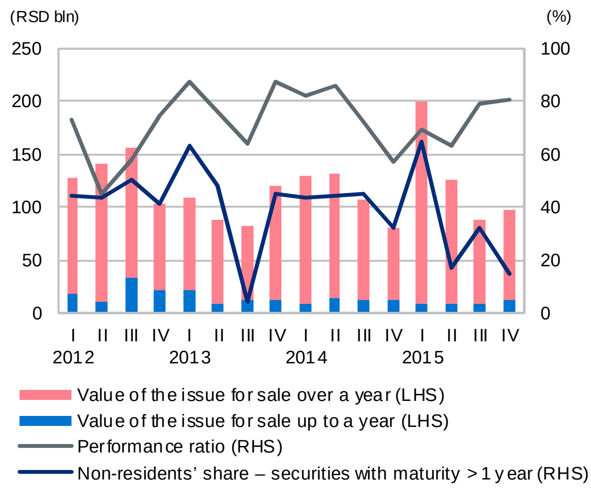
A more stable movement in interest rates in the interbank money market was supported by the NBS's decision from May 2015 to narrow the interest rate corridor relative to the key policy rate from ±2.5 pp to ±2.0 pp.

Monetary policy easing and much improved fiscal and external position of Serbia cut back on the costs of government borrowing in 2015. In early-year, rates at auctions of dinar government securities were on a mild rise, but began to decline in March. The fall continued until the year-end. In late 2015, the rates ranged between 2.9% for three-month and 6.5% for five-year maturity, whereby the dinar yield curve touched its lowest level ever. Compared to auctions held in late 2014, these rates fell by 3.1–4.1 pp. The rate on five-year securities was by 4.3 pp lower than at the previous August 2014 auction, primarily on account of a 4.0 pp cut in the key policy rate.

In 2015, the longest maturity at which the government would borrow in dinars was seven years. The last such borrowing took place in March, at a 10.8% rate, down by 1.2 pp from end-2014.

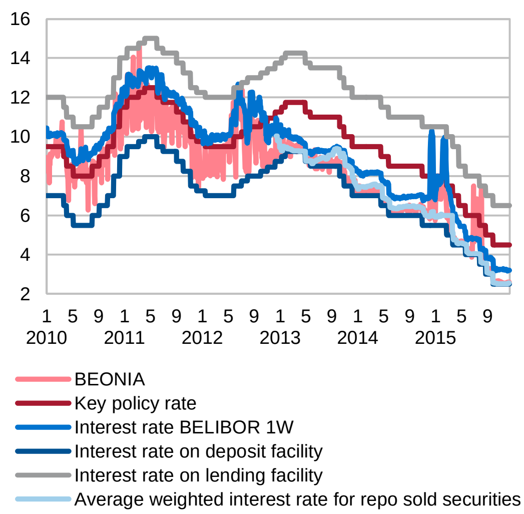
Reduced maturities and the smaller volume of securities offered for sale, including expectations of the start of the Fed's rate hike in H2, impacted on smaller non-resident

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



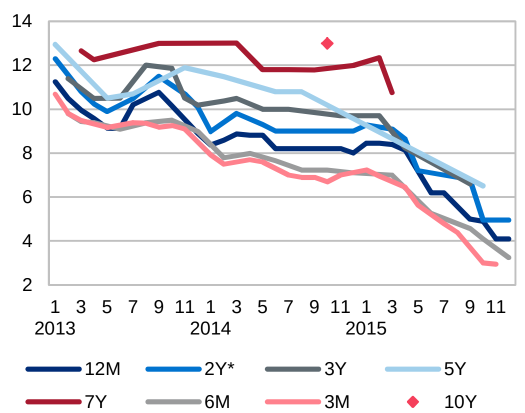
Source: Ministry of Finance.

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



Sources: Thomson Reuters and NBS.

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



Source: Ministry of Finance.

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

investment in this market. As of May, non-investors participated in two auctions only – of three-year securities in September and five-year securities in October.

Though milder than for dinar securities, a decline was recorded also at auctions of government euro securities. The drop was the steepest for two-year securities (by 1.7 pp to 1.8%). Rates on ten-year securities fell by 1.1 pp to 4.4%, rates on three- and five-year securities by 1.0 pp to 3.5% and 4.0% respectively, and rates on one-year securities by 0.9 pp to 1.6% pp. Only few foreign investors participated in the primary purchase.

Foreign investors were more active in secondary trading in government securities, particularly in Q4, mainly on the sale side. Total trading volumes expanded by 18.0% to EUR 337.7 bln. Most traded were bonds at the original three- and seven-year maturity. The rates of return mirrored the plummeting rates in the primary market. In December, they equalled between 2.9% for the remaining two-month and 7.5% for the remaining 73-month maturity.

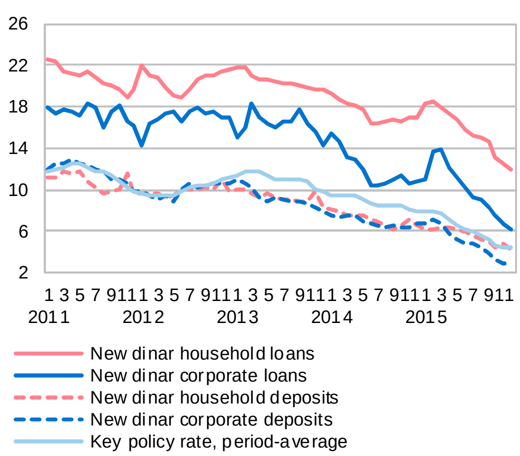
Owing primarily to monetary easing by the NBS in 2015 and lower interest rates in the international money market, the cost of private sector borrowing was reduced. Elevated bank competition in the credit market also added to the decline in interest rates. By end-2015, rates on new corporate and household loans touched their lowest levels on record.

Interest rates on dinar loans edged up in early-year, partly reflecting the winding-down of the subsidised loans programme, when relatively low rates determined the average cost of loans in H2 2014. These rates declined more steeply as of March as monetary easing stepped up. The average price of dinar corporate loans, one-digit from July, reached 6.2% in December, down by 4.7 pp from end-2014. Rates on household loans were down by 4.8 pp to 12.1%. At the same time, the average rate on dinar corporate and household loans lost 3.8 pp and reached 8.8% in December.

Rates on all types of dinar corporate and household loans were on a decline. In late 2015, rates on new dinar current assets and investment loans touched 6.1% and 7.2% respectively, down by 4.5 pp and 3.2 pp from end-2014. The sharpest decline in 2015 (6.2 pp) was noted for other loans, approved at the average rate of 6.4% in December. The average price of dinar household loans declined most notably on the back of falling rates on the most dominant, cash and other loans, which were down 12.1% and 12.0% respectively. At the year-level, rates on the least used – consumer (by 9.3 pp to 11.0%) and housing refurbishment loans (by 9.1 pp to 6.7%) declined the most.

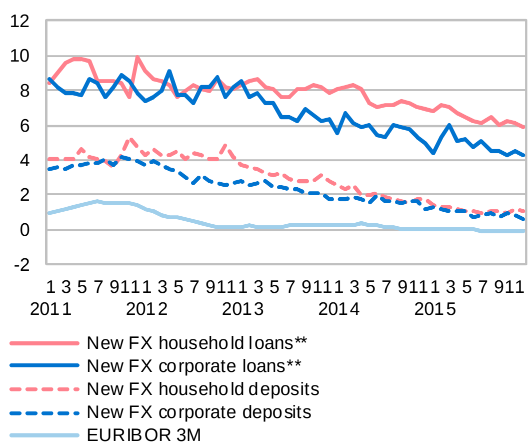
Though less than the dinar rate, the weighted average rate on new euro and euro-indexed loans fell by 0.7 pp to 4.4%. The average rate on corporate loans went down by the same amount and reached 4.2% in December, while

Chart III.3.5 **Interest rates on dinar loans and deposits of corporates and households***
(weighted average values, p.a., in %)



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

Chart III.3.6 **Interest rates on FX loans and deposits of corporates and households***
(weighted average values, p.a., in %)



Sources: NBS and European Banking Federation.
* Excluding revolving loans, current account overdrafts and credit card debt.
** Euro and euro-indexed.

the price of household loans declined by 1.0 pp to 5.9%. At the same time, investment and current assets loans were approved at 4.4% in late 2015, down by 0.5 pp and 0.6 pp compared to end-2014 respectively. The price of other corporate loans fell by 1.3 pp to 3.6%. The rate on housing loans, as the most widely used FX loans by households, edged down by 0.9 pp to 3.8% in 2015. Rates on cash and other loans also slipped, to 5.3% and 7.9% by end-2015 respectively. It was only the price of consumer loans that went up compared to end-2014 – it reached 6.3% in December.

According to bank lending surveys, a contraction in loan funding costs and enhanced bank competition were the main reasons why credit standards were eased. The fall in rates was more pronounced for new dinar deposits, which fell by 3.7 pp on average to 3.1% in December. Average rates on dinar corporate deposits dipped somewhat more (by 3.8 pp to 3.0%) than household deposit rates (by 2.3 pp to 4.2%). The weighted average rate on new euro deposits fell by 0.7 pp to 0.8% at end-2015. Rates on corporate and household deposits declined almost equally, and reached 0.6% and 1.1% in December respectively.

Country risk premium

Measured by EMBI, Serbia's risk premium mirrored regional dynamics. Compared to other countries in the region, it dropped more sharply at the year-level – thanks to improved macroeconomic prospects, notably the narrowing in internal and external imbalances, conclusion of the precautionary stand-by arrangement with the IMF and positive completion of the review of the arrangement. End-of-period, risk premium declined by 12 bp compared to 2014, or 58 bp on average. Of the countries observed in the region, it was only EMBI for Hungary that recorded the same-direction changes as Serbia's risk premium – in average (45 bp) and end-of-period terms (33 bp).

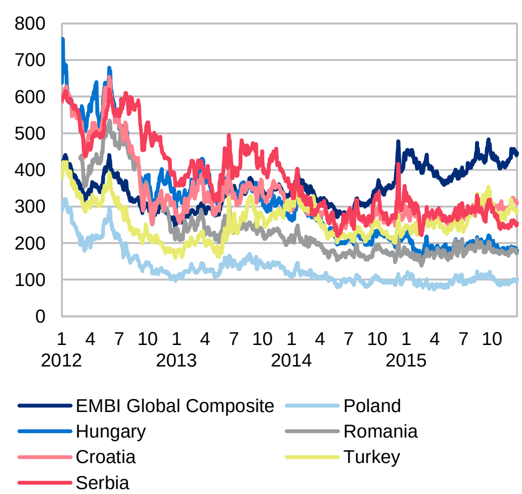
In early 2015, risk premia of countries in the region increased on the back of instability in the international financial market spurred by the expected divergent monetary policies of the leading central banks, uncertainties as to global oil prices, and geopolitical tensions. Owing to the ECB's decision to begin with quantitative easing in March and the consequently elevated liquidity in the international financial market, the risk premia of countries in the region were on a decline in the course of March. The fall was more pronounced in Serbia owing to consistent implementation of fiscal consolidation measures and conclusion of the arrangement with the IMF.

Over the following three months, Serbia's risk premium was relatively stable. In late June and in July, due to investor reaction to the Greek crisis it recorded a one-off increase in almost all countries in the region. In mid-August, uncertainties in the international financial market heightened again over China's stock market turmoil and expectations of the start of Fed's rate hike. As a result, risk premia of countries in the region went up again. In September, EMBI Global reached 483 bp, its highest level since October 2011.

Reflecting monetary easing by the Chinese central bank and the deferral of the Fed's rate hike, risk premia of emerging economies drifted down in October. Serbia's risk premium declined in October, but remained relatively stable until the year-end. Serbia's risk premium equalled 254 bp in late 2015.

Serbia's credit rating was affirmed in January 2015 by Standard&Poor's (BB- with negative outlook) and Fitch (B+ with stable outlook). In December, Fitch revised Serbia's outlook to positive from stable and affirmed its long-term foreign and local currency issuer default ratings. According to their assessment, the improvement in Serbia's credit rating was due to faster than expected economic growth, consistent implementation of the fiscal consolidation plan and narrowing in external imbalances.

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



Source: JP Morgan.

Trends in the FX market and exchange rate

The exchange rate of the dinar was relatively stable in 2015. In terms of end of period data, the dinar weakened by 0.5% against the euro. While appreciation pressures prevailed during much of the year, depreciation pressures mounted early in the year and during Q4.

As the difference between euro area and US monetary policies widened, the dollar made strong gains against the euro in Q1 and Q4. In Q2 and Q3, however, the euro strengthened moderately against the dollar amid market expectations of a deferral in Fed's policy rate hike. As the dollar gained 10.1% against the euro in 2015, the dinar lost 10.6% against the dollar relative to end-2014.

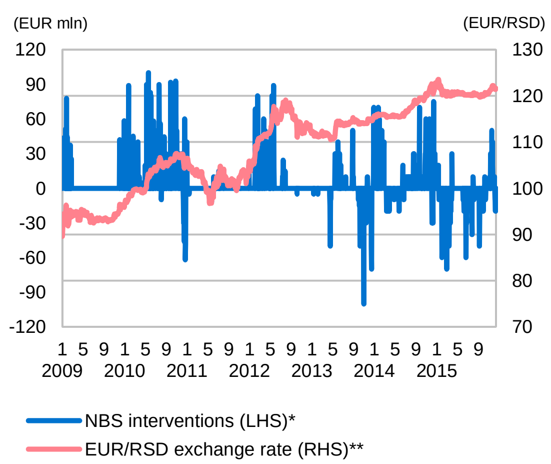
Depreciation pressures from late 2014 continued into January, due to an interplay of domestic and global factors. From February onwards, the dinar strengthened. FX demand of domestic companies, including in particular energy importers, increased in January. As trading volumes in the domestic FX market remained low, depreciation pressures mounted. In January, net non-resident investment in government securities also subsided, only to swell in February with the conclusion of a three-year stand-by arrangement with the IMF, against a backdrop of consistent fiscal consolidation. Improved liquidity in the international financial market resulting from new ECB's QE measures and low yield rates on securities of developed economies encouraged greater capital flows to emerging markets, Serbia included. As a result, non-resident investment in domestic dinar securities was high in February and March, pushing up non-resident demand for dinars.

FX demand of domestic companies declined from April on, which, together with a significantly lower current account deficit and a relatively high inflow of remittances, underpinned exchange rate stability over the coming months. The inflow of remittances, but also the redemption of a new series of frozen FX savings bonds, led to higher purchases of foreign cash in exchange operations. FX supply also went up as a result of FDI inflows, while external government borrowing increased. Banks increased their FX supply, faced with the maturing of earlier extended subsidised loans and a rise in currency-indexed assets on other grounds.

Depreciation pressures prevailed in Q4, due to subdued activity of non-residents. Anticipating the onset of the Fed's monetary tightening, non-residents started reducing their exposure to emerging markets, including to Serbia. In part, higher FX demand in the domestic market in Q4 was due to increased payments for energy imports and dividend payments to foreign owners. At the same time, as usual at the end of the year, banks and corporates somewhat increased the repayment of foreign loan obligations.

Though depreciation pressures prevailed late in the year, investors' risk perception regarding long-term investment in Serbia was favourable in 2015, as reflected in net FDI inflows which, at EUR 1.8 bln in 2015, were much higher than in 2014. Successful completion of **three reviews**

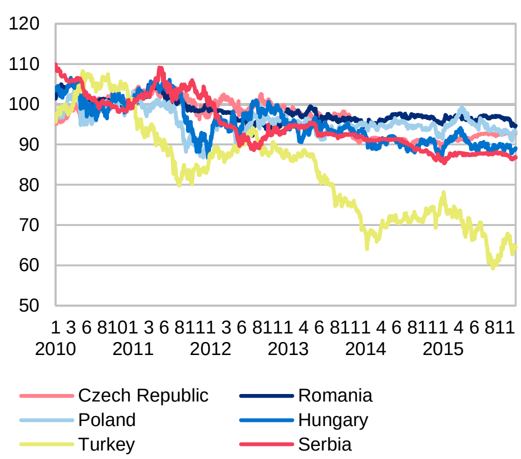
Chart III.3.8 **Movements in EUR/RSD exchange rate and NBS FX interventions**



Source: NBS.

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

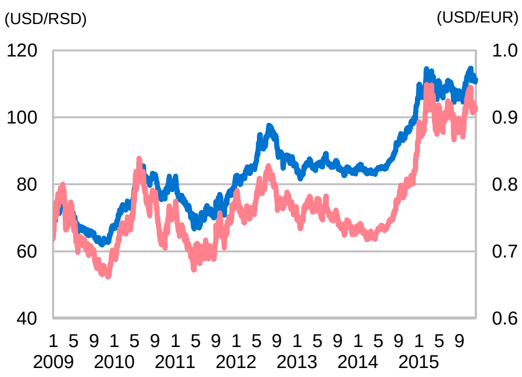
Chart III.3.9 **Movements in exchange rates of national currencies against the euro***
(daily data, 31 December 2010 = 100)



Sources: NBS and websites of central banks.

* Growth indicates appreciation.

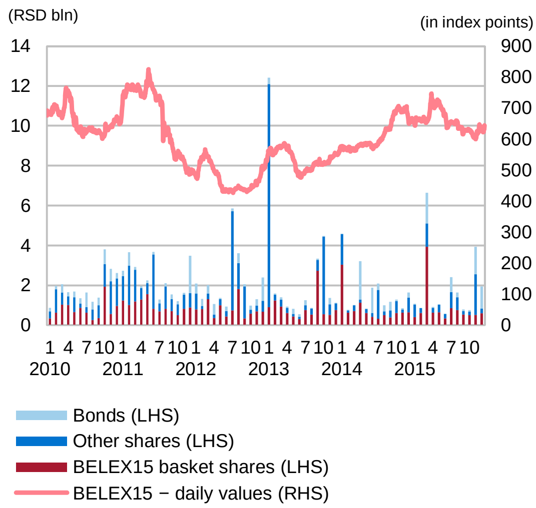
Chart III.3.10 **Movements in RSD/USD and EUR/USD exchange rates**



Source: NBS.

* 1 USD in RSD.
** 1 USD in EUR.

Chart III.3.11 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

under the IMF stand-by arrangement, raised credit rating outlook by the *Fitch* rating agency and headway made in the EU accession process confirm Serbia's progress in achieving macroeconomic stability and improving the business environment, while at the same time supporting expectations that the relative stability of the dinar will be maintained in the period ahead.

To moderate excessive short-term exchange rate volatility, in 2015 the NBS intervened in the IFEM in both directions – by buying EUR 970.0 mln and selling EUR 450.0 mln (net purchase of EUR 520 mln).

Stock exchange trends

At end-December, BELEX15 (the index of the most liquid shares) came at 644.1 index points, or 3.4% down from end-2014, by contrast to BELEXline which gained 2.7% to reach 1,380.4 index points. Belgrade Stock Exchange (BSE) indices remained broadly flat during Q1. They spiked in April, but began to decline around mid-May, probably due to the escalation of the Greek crisis, mounting risks in the global financial market (especially in August and September), and the fact that companies from the oil sector have a significant share (19%) in the composition of the BELEX15 index. Though indices rallied in Q4, the recovery of BELEX15 did not suffice to offset the fall recorded in Q3.

Despite rising mildly relative to 2014 (by RSD 1.7 bln), trading in shares was relatively low in 2015. Total trading in shares in the BSE in 2015 came at RSD 17.3 bln, of which RSD 10.4 bln related to trading in most liquid shares. Trading volumes peaked in March (RSD 5.1 bln), mostly as a result of trading in the open market segment[10], primarily with bank shares.

In 2015, foreign investors accounted for around 40% of total trading in shares. Similarly as in 2014, they were net sellers of shares worth a total of RSD 2.8 bln.

Total trading in bonds increased from RSD 4.7 bln in 2014 to RSD 5.3 bln in 2015, helped by the decision to include long-term Republic of Serbia bonds in the BSE listing in November. Trading in these securities amounted to RSD 1.6 bln, with the remainder mostly related to trading in frozen foreign currency savings bonds.

Long-term government securities were traded in the first interbank repo transaction on the Serbian financial market, concluded in line with the standard Master Repo Agreement. The NBS also took part in its preparation. This marks a step forward in the development of the domestic financial market as repo transactions were

[10] A part of the regulated market comprising shares not eligible for BSE shares listing.

previously conducted only between the NBS and banks in open market operations. Given that the underlying security in the said repo transaction is a long-term dinar government bond, the development of these transactions could also boost the liquidity of the secondary market of government securities.

BSE market capitalisation declined by RSD 113.3 bln in 2015 to RSD 683.4 bln at end-December. Regulated market capitalisation shrank by RSD 73.0 bln to RSD 377.2 bln, partly as a result of a fall in shares prices, maturing of A2015-series bonds in May, but also due to the exclusion from trading of shares of certain issuers. MTP capitalisation[11] went down by RSD 40.3 bln to RSD 306.2 bln. As a result of such movements, the share of market capitalisation in estimated GDP[12] edged down by 3.2 pp to 17.2% at end-2015.

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

	Dec. 2014	Dec. 2015	Changes in 2015
Net foreign assets	**1,181,851**	**1,264,741**	**82,890**
Net FX reserves	1,179,936	1,260,428	80,492
Gross FX reserves	1,198,357	1,262,232	63,875
IMF loans	-18,421	-1,804	16,617
Other net foreign assets	1,915	4,313	2,398
Net domestic assets	**-572,391**	**-613,250**	**-40,859**
Net domestic NBS loans	-278,220	-284,677	-6,457
Net loans to government[1)]	-256,415	-227,643	28,772
Government loans	1,223	1,181	-42
Government deposits	-257,638	-228,824	28,814
Net claims on banks	-6,889	-29,932	-23,043
Loans to banks	625	711	86
Repo operations	-7,500	-30,600	-23,100
Other securities	-14	-43	-29
Loans to public enterprises	1,183	1,154	-29
Loans to non-bank financial institutions	2,562	1,213	-1,349
Loans to other sectors	1,168	1,160	-8
Term and restricted deposits	-19,829	-30,629	-10,800
Other net assets	-294,171	-328,573	-34,402
Reserve money	**609,460**	**651,491**	**42,031**
Dinar reserve money	370,690	421,668	50,978
Currency in circulation	130,468	139,818	9,350
Dinar reserves of banks	211,628	248,495	36,867
Required reserves	158,126	145,324	-12,802
Excess reserves	53,502	103,171	49,669
Other deposits of other sectors	2	331	329
Local government deposits	28,592	33,024	4,432
FX bank deposits	238,770	229,823	-8,947

1) Excluding local government authorities.
Source: NBS.

4 Money and loans

Reserve money

In 2015, dinar reserve money gained 13.8% in nominal and 12.1% in real terms in 2015. Total reserve money increased less (by 6.9% in nominal and 5.3% in real terms), as FX bank deposits with the NBS contracted after FX reserve requirement ratios were relaxed. In absolute terms, dinar reserve money gained RSD 51.0 bln and total reserve money – RSD 42.0 bln.

In 2015, dinar reserve money increased mostly on account of net FX purchases by the NBS in the IFEM (RSD 50.2 bln) and payment transactions with Kosovo and Metohija (RSD 47.0 bln). At the beginning and end of the year, NBS's net FX sales in the IFEM acted to mop up liquidity, while in the remaining part of the year the NBS was the net buyer of FX, so that the overall effect of its interventions in 2015 worked in the direction of increasing bank liquidity. By contrast, government dinar deposit balances with the NBS gained RSD 22.0 bln, as a result of fiscal consolidation and improved fiscal discipline. Also, the government bought FX from the NBS during the year in order to service its FX obligations. As a result of this, and a rise in dinar deposits, the government contributed RSD 47.4 bln to the reduction in bank liquidity in 2015. On the other hand, government FX deposits with the NBS declined through payment of its obligations to non-residents and RSD 23.1 bln was withdrawn in open market operations. Banks' investment in repo securities slumped early in the year, driving up liquidity, only to act in the opposite direction when, after a six-week break when the NBS did not hold repo auctions, banks' investment in repos increased.

A breakdown of dinar reserve money shows that banks' excess reserves[13] increased most in 2015 (by RSD 49.7 bln), mainly on account of higher overnight deposits of banks held with the NBS, while banks' gyro account balances contracted. The amount of required reserves allocated in dinars shrank by RSD 12.8 bln following

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

[12] Estimated GDP in the last four quarters.

[13] Including funds on bank gyro accounts, vault cash and overnight bank deposits with the NBS.

relaxation of required reserve regulations, as did the dinar allocations of FX required reserves. Currency in circulation increased by RSD 9.4 bln, and balances in accounts of local government and other sectors by RSD 4.4 bln and RSD 0.3 bln, respectively.

Monetary aggregates M1, M2 and M3

The velocity of circulation of the money supply, particularly dinar aggregates, declined with the recovery of economic activity.

The money supply increased in 2015, primarily due to the growth recorded in H2. Dinar transaction deposit balances increased the most (RSD 64.3 bln), and savings and time dinar deposits gained RSD 14.7 bln. As a result, monetary aggregates M1 and M2 recorded real growth of 15.4% and 12.7%, respectively. As FX deposits also increased, by EUR 319.7 mln, the broadest monetary aggregate M3 rose by 5.6% in real terms.

After a considerable period of time, lending to the private sector provided an impulse to M3 creation from H2 onward, and bank investment in government securities worked in the same direction.

The rise in dinar deposits, of shorter and longer maturities alike, was mostly due to increased corporate and household account balances. In the case of the corporate sector, the bulk of the increase was recorded in account balances of companies from the manufacturing, energy, trade, real estate and transport industries. At the same time, balances in accounts of OFO also increased, though marginally.

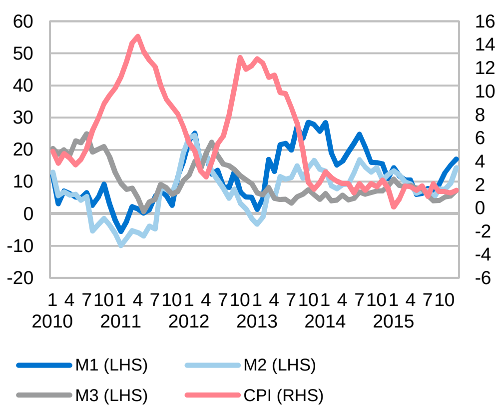
Dinar household savings have been rising steadily from April 2015 onwards, sustained by an extended period of low and stable inflation, relatively stable exchange rate, higher interest rates and preferential tax treatment of dinar relative to FX savings. They increased by RSD 7.3 bln during 2015 to RSD 45.4 bln at year end, with households opting most frequently for demand and one- to two-year time savings deposits. At the same time, household FX savings gained RSD 86.0 mln and reached EUR 8.3 bln at end-2015.

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

	Dec. 2014	Dec. 2015	Changes in 2015
Net foreign assets	**1,036,784**	**1,086,787**	**50,003**
Bank net foreign assets	-145,067	-177,955	-32,888
Net domestic assets of the banking sector	**828,659**	**912,782**	**84,123**
Net domestic loans	2,048,253	2,203,653	155,400
Net claims on government	122,669	223,360	100,691
Government loans	458,249	539,657	81,408
Government deposits	-335,580	-316,297	19,283
Loans to other resident sectors	1,925,584	1,980,293	54,709
Loans to households	725,455	759,875	34,420
Loans to the corporate sector	1,140,200	1,162,049	21,849
Loans to other financial corporations	23,588	24,770	1,182
Loans to local authorities	35,246	32,193	-3,053
Loans to non-profit and other organisations	1,095	1,406	311
Other net assets	-1,219,594	-1,290,871	-71,277
Money supply M3	**1,865,443**	**1,999,569**	**134,126**
Money supply M2	614,259	702,590	88,331
Money supply M1	430,915	504,516	73,601
Currency in circulation	130,468	139,818	9,350
Transaction deposits	300,447	364,698	64,251
Dinar savings and term deposits	183,344	198,074	14,730
FX deposits	1,251,184	1,296,979	45,795

Source: NBS.

Chart III.4.1 **Monetary aggregates and CPI**
(y-o-y rates, in %)



Sources: SORS and NBS.

In addition to household FX savings deposits, corporate FX deposits, sustained by higher exports, also increased, while balances in accounts of other sectors – OFO, non-profit organizations and local governments – subsided.

The ratio of money supply M3 to NBS FX reserves declined in the course of the year by 1.1 pp to 63.1% in December.

Bank lending

Bank lending recovered moderately in 2015, despite the maturing of subsidised loans approved in 2014. The pick up in lending was due to monetary easing and the consequent fall in interest rates on dinar loans, as well as to low international money market interest rates. A part of the lending potential was also released through a new round of cuts in the FX reserve requirement ratios.

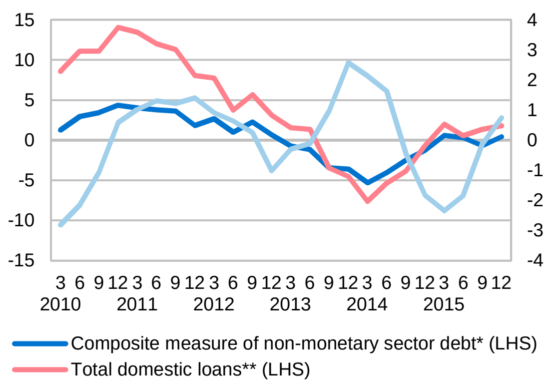
Although around RSD 110 bln, or 80.0% of subsidised loans approved in the prior year matured for payment in 2015, total domestic loans, excluding the exchange rate effect, gained 1.8% and their share in estimated GDP climbed 0.7 pp to 48.7% in December.

To finance their lending activity, banks relied on domestic sources of funding, including primarily dinar and FX corporate and household deposits.[14] A part of the lending potential was also released through the trimming of FX reserve requirement ratios.

Excluding the exchange rate effect, corporate loans went up by RSD 13.7 bln or 1.2% in 2015. As a result of higher lending in H2, loans to companies increased by RSD 16.4 bln in 2015, while loans to public enterprises contracted by RSD 2.7 bln. Given that, as seasonally expected, fewer new loans were approved by banks early in the year and instalments of subsidised loans came due, banks' receivables on this account declined. Movements were more favourable from Q2 onwards, as confirmed by the higher value of new loans. As before, loans for current assets were dominant, making up around 43% of new loans in 2015, while other loans accounted for around 25%. The share of investment loans in new loans climbed to 29.0% (from 15.0% in 2014), which is a positive signal of increased reliance of corporates on this type of investment funding in 2015. Thanks to the rise in investment loans (by around 150% y-o-y to RSD 222.8 bln), the value of total new loans in 2015 (RSD 747.9 bln) exceeded their value from 2014 (RSD 542.5 bln) when the subsidised lending scheme was in place. Positive trends are also reflected in the fact that, even excluding loans refinanced under more favourable terms (around 25.0%), new corporate loans were 4.0% higher in 2015 than total new loans in 2014. The rise in investment loans contributed to the lengthening of the maturity of the loan portfolio, with the share of loans maturing in over two years rising by 6.8 pp to 64.3%. Borrowing by companies belonging to the energy, trade and agriculture sectors increased most in 2015, while loan receivables slumped most notably in the manufacturing industry sector, as the largest beneficiary of subsidised loans.

According to the results of the bank lending survey,[15] the trend of relaxation of corporate lending standards began in Q2 and continued throughout H2. Banks ascribed this to cheaper sources of funding and increased competition among banks. Though diminishing, risks in relation to the collection of receivables and collateral, as well as those relating to growth prospects, persisted. Margins and associated costs continued to trend down in 2015, and corporates were also offered more favourable terms of repayment. Requirements regarding maximum loan amount were eased in H2, while collateral requirements

Chart III.4.2 **Lending activity and GDP**
(y-o-y rates, in %)



Sources: NBS and SORS.

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

** Excluding the exchange rate effect.

[14] Although lending activity recovered, receivables in this respect increased less than the deposit base; as a result, the loan-to-deposit ratio (LTD) declined by 3.6 pp to 107.5% in 2015.

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

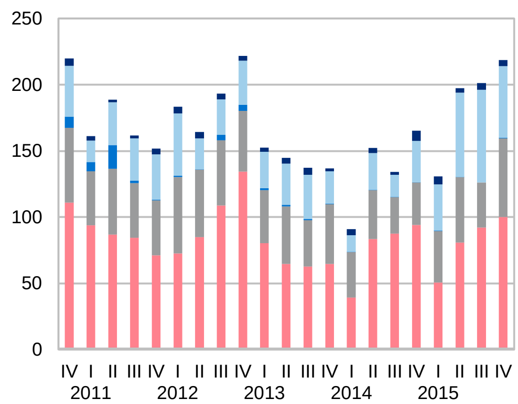
were relaxed in Q3 only to be tightened again in Q4. After recording a seasonal drop in Q1, loan demand of corporates increased over the next three quarters, motivated, according to banks, by the need to finance current assets and refinance existing obligations.

Contrary to expectations, the cut in public sector wages and pensions did not weigh down on borrowing by households. Household loans thus moved in line with the usual seasonal trends in 2015 and, after slackening as usual at the start of the year, recorded relatively stable growth in later months. Household loans gained RSD 20.4 bln or 3.1% in 2015. Households opted most for cash loans, which made up more than a half of new loans (54%). Housing loans remained relatively low. Consumer loans increased moderately, while costlier loan categories – credit cards and current account overdrafts – remained broadly unchanged from the prior year. Out of RSD 269.9 bln of total new household loans in 2015, around 19% referred to existing loans with modified terms of repayment. A part of this relates to modified terms of repayment of existing, primarily housing loans, following the implementation of the Decision on Measures for Preserving Stability of the Financial System in the Context of Foreign-Currency Indexed Loans[16] , adopted by the NBS in February 2015.

According to the results of the bank lending survey, household loans increased due to steady relaxation of standards in 2015, which was guided by the same reasons as in the case of corporate loans. Standards were relaxed for all housing loan categories, dinar and FX alike. Throughout the year, banks narrowed their interest rate margins and trimmed associated costs, while in H2 some even eased their requirements with regard to collateral. After being lengthened in Q2, repayment terms remained unchanged until year end. According to banks, household demand for loans was stagnant in Q1 and increased during the rest of the year, motivated primarily by the need to refinance existing obligations. As a result, cash and refinancing loans were the most in demand.

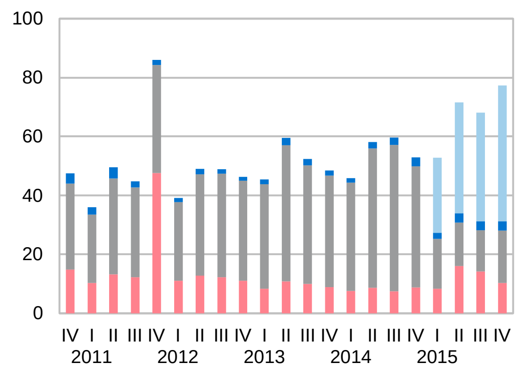
According to the responses in the bank lending survey, non-performing receivables, along with expectations regarding economic activity, were the key factor hindering the relaxation of lending standards. At 21.6% in late 2015, the share of NPLs in total loans, on a gross basis, remained almost unchanged from end-2014. In the corporate sector, which accounts for the bulk of the loan portfolio, the share of NPLs subsided by 2.9 pp to 21.7%, due to the recovery of lending, but also to the collection, write-off and restructuring of a portion of the NPLs portfolio. The share of household NPLs gained 0.6 pp to

Chart III.4.3 **Structure of new corporate loans**
(RSD bln)



Source: NBS.

Chart III.4.4 **Structure of new household loans**
(RSD bln)



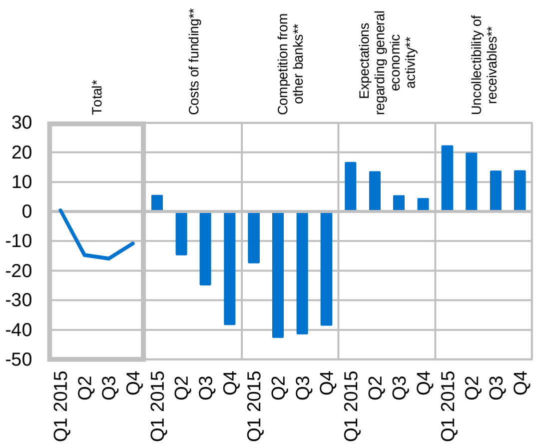
Source: NBS.

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

[16]http://www.nbs.rs/internet/english/20/zast/finansijska_stabilnost_krediti_e.pdf.

[17] Entrepreneurs and private households included, the share increased by 0.6 pp to 11.8%.

Chart III.4.5 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to enterprises**
(in net percentage)

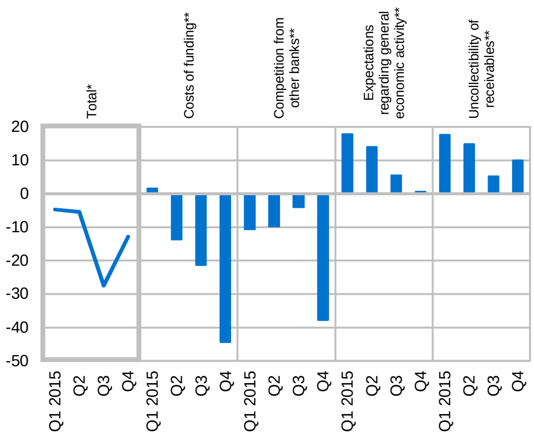


Source: NBS.

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

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

Chart III.4.6 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to households**
(in net percentage)



Source: NBS.

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

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

10.9%[17]. The implementation of the NPL Resolution Strategy, drafted by the Government and the National Bank of Serbia, in cooperation with the IMF, World Bank and European Bank for Reconstruction and Development, and adopted by the Government in August 2015, is expected to provide a market-based, sustainable solution to the issue of NPLs.

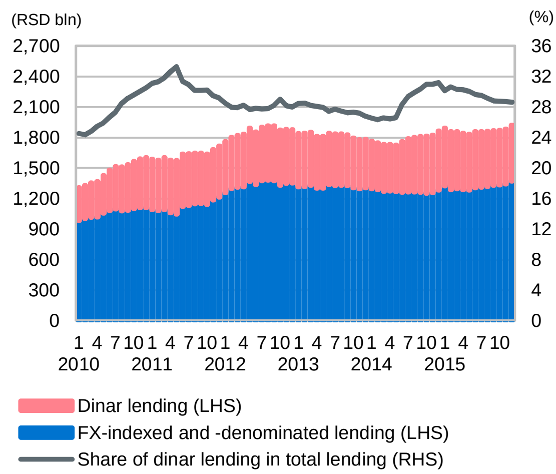
Despite the high share of NPLs in total loans, the capital adequacy ratio of around 21% indicates that the domestic banking sector is stable. In 2015, total allowances for loan impairment increased by 7.9 pp to 66.8% of NPLs in December, while loan loss provisions,[18] at 114.2% in December, still fully covered the amount of gross NPLs.

High capitalisation of the banking sector has also been confirmed by the results of special diagnostic studies of banks' balance sheets conducted as at 31 March 2015, which included 14 banks accounting for 88.0% of banking sector assets.[19]

5 Dinarisation

Serbia's dinarisation strategy is built around three interconnected pillars. The first includes activities

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 for the calculation of bank capital. They are calculated on a group basis by asset classes that provisioning levels are defined for (0%, 2%, 15%, 30% and 100% for receivables classified in A, B, C, D and E categories, respectively).

[19] The report on special diagnostic studies of banks is available at: http://www.nbs.rs/internet/english/55/55_0/2015_aqr_izvestaj_e.pdf.

designed to create a macroeconomic environment of low and stable inflation, stable financial system and sustainable economic growth. The second 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.

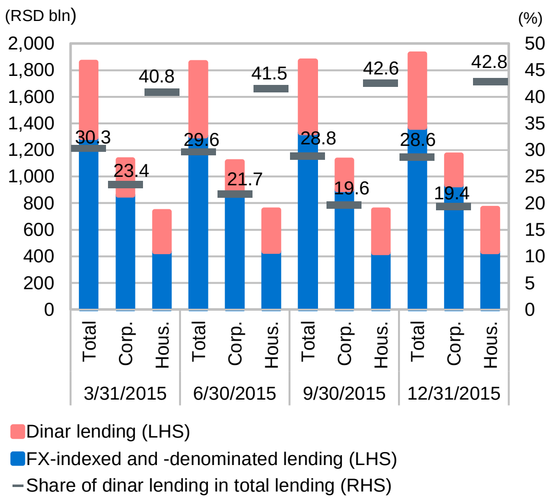
Recognising the need to increase the use of the dinar in the financial system in order to strengthen the country's financial stability, lessen the exposure of the most vulnerable sectors of the economy to the currency risk, reinforce the efficiency of monetary policy and, by extension, create preconditions 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.

During 2015, through its required reserves policy, the NBS continued to encourage banks to use dinar sources of funding. Namely, despite the trimming of the FX required reserve ratio, the ratios on dinar sources are still much lower than on FX ones, and the NBS remunerates dinar required reserves only.

The NBS has continued to work on further development of basic FX hedging instruments. During 2015, regular two-week and three-month FX swap auctions were organised, encouraging interbank swap trading and the development of instruments for liquidity management and FX hedging.

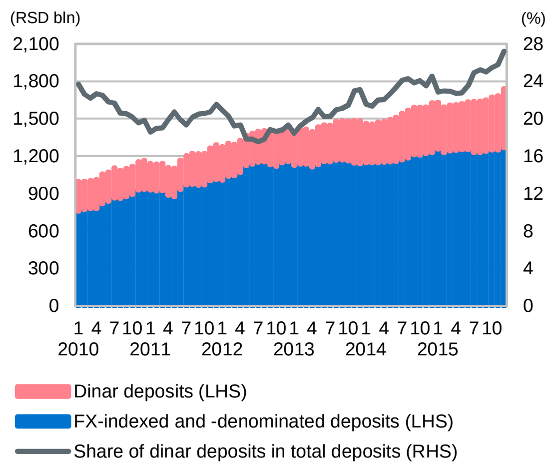
From the standpoint of dinarisation, it is particularly significant that long-term government securities have been listed for trading on the Belgrade Stock Exchange as of November 2015. This has helped expand the base of investors in government securities, contributing to the liquidity of the secondary market of government securities and the development of other financial instruments in the capital market. Since 12 November 2015, when these securities were first included on the Prime BSE listing, until the end of the year, the total trading volume in dinar and FX government securities in this market came at RSD 350.6 mln and EUR 10.4 mln, respectively.

Chart III.5.2 **Lending by sector**



Source: NBS.

Chart III.5.3 **Share of dinar deposits in total corporate and household deposits**



Source: NBS.

The degree of dinarisation, measured as the share of dinar loans in total corporate and household lending, saw divergent movements in 2015.

The degree of dinarisation of corporate loans contracted in 2015, as a result of a fall in dinar corporate loans (by RSD 31.6 bln) and an increase in FX-indexed and FX loans (by RSD 88.5 bln). This was mainly the result of the maturing of dinar subsidized loans approved in 2014, which were for a good part substituted by FX-indexed loans. As a result, the share of dinar in total corporate loans shrank by 5.6 pp in 2015 to stand at 19.4% at year end.

By contrast to corporate loans, dinar household loans continued to rise. In 2015, they gained RSD 28.3 bln, mostly as a result of higher cash loans. FX and FX-indexed household loans increased less (RSD 6.4 bln). As a result, the degree of dinarisation of household loans gained 1.8 pp during 2015 to stand at 42.8% at year end.

The degree of dinarisation of deposits, measured by the share of dinar deposits in total corporate and household deposits with banks, came at 27.2% at end-2015, up by 2.7 pp from end-2014.

The share of dinar deposits of both households and corporates in total deposits edged up mildly to 13.9% and 55.6%, respectively, at end-2015 (from 11.5% and 53.6% in 2014, respectively). Although the share of dinar household deposits remains relatively low, it has been trending up steadily mostly on account of an upswing in dinar household savings which, at end-2015, came at RSD 45.4 bln or 7.3 bln more than at end-2014.

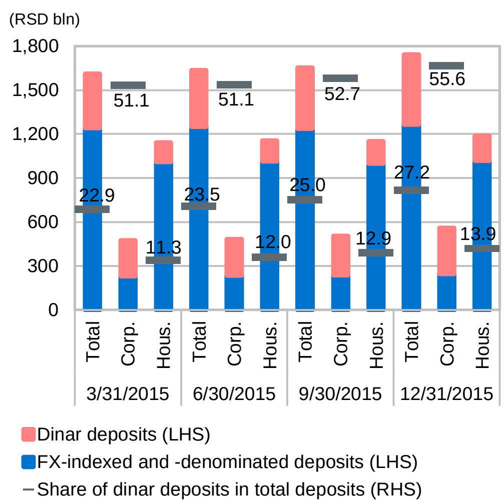
The degree of dinarisation measured by the share of dinar debt in total public debt also went up to 22.2% in December, or 0.8 pp more than at end-2014.

6 Inflation expectations

Owing to a long spell of low inflation and low expected inflationary pressures, inflation expectations of the financial and corporate sectors are the lowest on record, at both one and two years ahead. **Anchored inflation expectations confirm the confidence of market participants in measures taken by the National Bank of Serbia.**

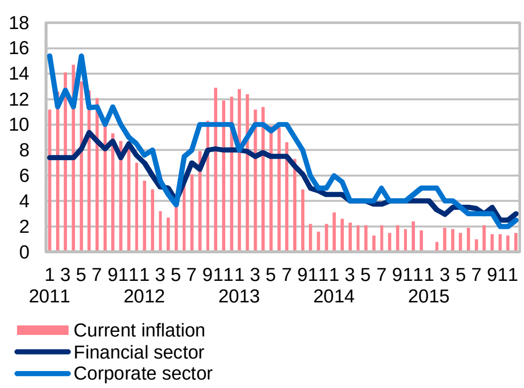
Inflation expectations of financial and corporate sectors continued to move within the target tolerance band throughout 2014 and dropped further in 2015. According to the **Bloomberg survey, 12-months ahead** inflation expectations of the financial sector matched the inflation

Chart III.5.4 **Deposits by sector**



Source: NBS.

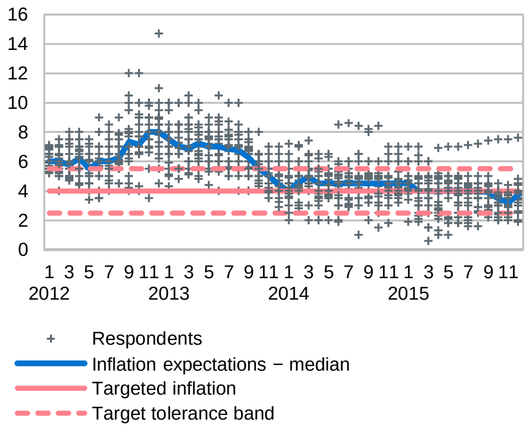
Chart III.6.1 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, %)



Sources: Gallup, Ipsos, Ninamedia and NBS.

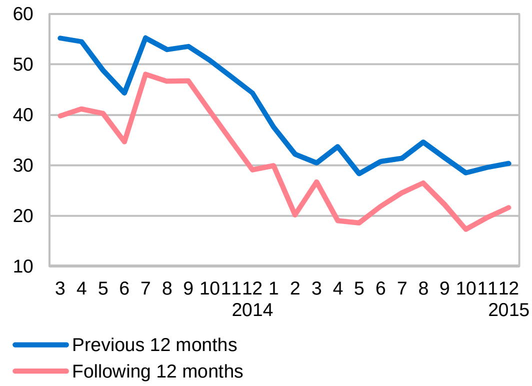
* Ninamedia agency since December 2014, and Ipsos and Gallup in the prior period. The survey was not conducted in November 2014.

Chart III.6.2 **Targeted inflation and one-year ahead inflation expectations – financial sector**
(y-o-y rates, in %)



Sources: Bloomberg and NBS.

Chart III.6.3 **Inflation perceived and expected by households**
(in index points)



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

target central point (4.0%) for most of the year under review. In the closing months of 2015, inflation expectations of the financial sector subsided further, ranging from 3.9% to 3.2%. **Ninamedia**[20] **survey** reported somewhat lower inflation expectations of the financial sector, ranging from 4.0% to 2.5%. Corporate inflation expectations were on a constant decline, from 5.0% in early 2015, to 2.0% in October and November, while rising to 2.5% in December.

Although typically higher, inflation expectations of the household sector stabilised within the target range at around 5.0%. They inched up temporarily only in July and August (to 8.0% and 7.0%, respectively), mostly due to the increase in electricity prices. As regards qualitative inflation expectations of households, both perceived and expected inflation extended their fall in place since mid-2014, losing almost 30 index points by mid-2015. In the period thereafter both were relatively stable. Given that actual inflation has been low for quite a while now, perceived inflation of households, in spite of a sizeable fall, remains overestimated. Still, perceived inflation is higher than expected inflation, which suggests that one part of the population which is under the impression that prices have risen over the past 12 months does not expect such trend to continue, but anticipates a stabilisation or a drop of prices in the year ahead. The year 2015 also witnessed favourable movement of mid-term inflation expectations of all sectors. The financial sector generally expected that **inflation two years ahead** would be on target, and in some months lowered its expectations to 3.5%. Medium-term inflation expectations of the corporate sector followed a similar path, but dropped further down around end of the year, to the lower bound of the target tolerance band (2.5%). Mid-term inflation expectations of households were higher, but stabilised as of February 2015 at 5.0%.

During 2015, both Bloomberg and Ninamedia surveys reported relatively stable response dispersion for the financial sector, which traditionally shows the smallest disagreement among respondents. At the same time, the dispersion of corporate responses continued to narrow further during the year, as it became more and more certain that there would be no significant inflationary pressures. Dispersion of household responses decreased in H1 and remained relatively stable thereafter.

7 Fiscal policy

Late 2014 saw the launching of a three-year fiscal consolidation program, aimed at halting the growth of public debt and ensuring the sustainability of public

[20] As of December 2014, the survey of economic agents' expectations is conducted by Ninamedia Press Clipping d.o.o Novi Sad, using the same methodology as applied earlier.

finances. The key measure on the expenditure side of the budget was cutting down public sector wages and pensions and rightsizing of the public sector, while priority measures on the revenue side were curbing of grey economy and the suppression of tax evasion. The program was further propped up by the conclusion of a three-year precautionary stand-by arrangement with the IMF in February 2015.

In the first year of fiscal consolidation, the consolidated budget deficit narrowed substantially and all quantitative performance criteria under the IMF arrangement were met, while fiscal indicators exceeded expectations.

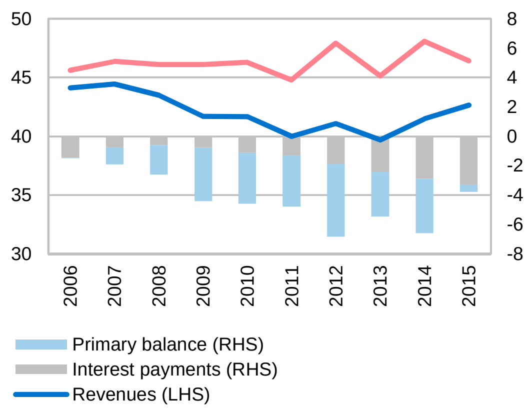
Consolidated budget deficit in 2015 came at RSD 148.6 bln or 3.8% of estimated GDP, which is by 2.8 pp lower than in 2014. Given that interest expenses accounted for a significant portion of the deficit (over 85%), primary deficit measured only 0.5% of GDP. Broken down by level of government, consolidated deficit resulted from the deficit of central government[21], mainly deficit of the Republic of Serbia (3.2% of GDP).

In 2015, **consolidated revenue** reached RSD 1,694.8 bln, rising by 3.0% in real terms compared to 2014. Government revenue grew mainly on the back of non-tax receipts, notably excise and VAT revenue. High real growth in non-tax revenue (27.7%) resulted chiefly from profit and dividend payments by state-owned enterprises into the Republic budget and wage reductions in public enterprises and local governments, also shown under this budget item. Excise revenue recorded a real growth of 9.3%, mainly owing to a better collection of excises on tobacco and petroleum products, prompted by stricter inspection of producers and sellers of tobacco products and broader coverage of the petroleum product marker program. Electricity excise enforced in August also boosted excise revenue, though in a smaller amount. In 2015 government revenue rose also on account of higher VAT revenue from imported goods, offset in part by lower VAT revenue from domestic products.

Increased collection of customs duty (real growth of 5.8%) also pushed government revenue up, while the proceeds from corporate income tax recorded the sharpest fall (15.1%). A real decline was also noted in regard to contributions (2.2%) and personal income tax (1.3%).

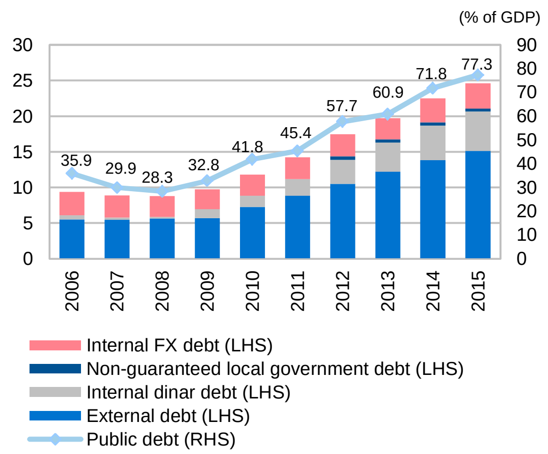
Consolidated expenditure came at RSD 1,843.4 bln in 2015, dropping by 3.3% in real terms from the year before. The main driver of the decline was the cutdown in wages in the sector of general government and pension cuts. Relative to 2014, wage expenditure dropped by

Chart III.7.1 **Fiscal revenues, expenditures and result**
(% of GDP)



Sources: Ministry of Finance and NBS.

Chart III.7.2. **General government public debt***
(EUR bln and % of GDP)



Source: Ministry of Finance.
* Non-guaranteed local government debt is included as of 2012.

[21] Central government includes: the Republic of Serbia Budget, Pension and Disability Insurance Fund, National Health Insurance Fund, National Employment Agency, Military Social Insurance Fund and public enterprises Roads of Serbia and Corridors of Serbia, while the local level of government includes municipalities and cities and the Autonomous Province of Vojvodina.

9.8% in real terms and pension expenditure by 4.9%. Budgetary loans worked in the same direction, shrinking by over 95%.

On the other hand, a real increase relative to 2014 was recorded for capital expenditure, social benefits, subsidies and interest payments. Capital expenditure grew by 16.7% in real terms, reflecting a sizeable increase of investment into road infrastructure. A rise in expenditure for subsidies (13.0%) and social benefits (16.3%) was driven mainly by settlement of one-off liabilities at the close of the year. These liabilities included arrears in respect of subsidies to agricultural producers, assumption of Srbijagas's debt to NIS and debt to military pensioners. As a result, expenditure rose above the initially planned amount. On the other hand, interest payment expenditure, though high (rising by 11.1% in real terms relative to 2014), were lower than planned, owing to more favourable terms of government borrowing.

Budget deficit was mostly financed through sale of government securities in the domestic market. In 2015, government debt in respect of dinar securities increased by RSD 88.0 bln (to RSD 638.6 bln), while the debt in respect of euro securities grew by EUR 429.8 mln (to EUR 2.2 bln).

General government debt[22] rose by EUR 2.0 bln in 2015, reaching EUR 25.2 bln at end of year.[23] At end-2015, 77.8% of public debt was foreign currency denominated (around one third in dollars and some 40% in euros). The euro's depreciation against the dollar of around 10% in 2015 pushed the public debt up by EUR 900 mln. Its share in GDP inched up by 5.5 pp to 77.3%, thus continuing the rise above the mandated limit of 45%. Nevertheless, consistent continuation of fiscal consolidation should stabilise public debt by 2017 and put it on a declining path thereafter.

8 Aggregate demand

On the expenditure side, the estimated GDP growth of 0.74% in 2015 was mostly driven by fixed investments. Positive, though lesser, contribution came from net exports as well, since exports grew faster than imports. Final consumption gave a negative contribution to GDP, though less so than in 2014.

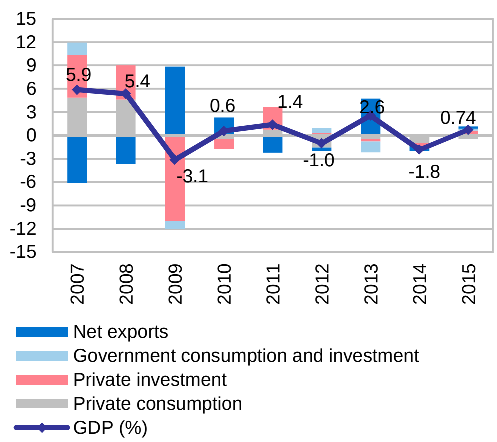
In quarterly terms, Q1 saw GDP shrinking by 1.8% in y-o-y terms, due to a negative contribution of consumption and net exports, which was stronger than the positive impulse from investment. However, in the ensuing two quarters exports grew much faster than imports, favourably impacting GDP growth. Negative contribution of final consumption to GDP subsided in the course of the year, becoming neutral in Q4.

Domestic demand

Successful continuation of fiscal consolidation measures affected **household consumption** in 2015 as well. This component dropped by 0.6%, pushing GDP down by 0.4 pp. However, the short-term negative effects gradually abated in the course of the year. This is indicated by retail turnover, which declined in Q1 and posted s-a growth in the following quarters, and by imports of consumer goods, which were on the upswing in H2. A similar trend was recorded for main sources of consumption – the wage bill and social insurance transfers, which, starting from Q2, recorded quarterly growth in s-a terms.

The main positive impetus to GDP in 2015 came from private investment (1.1 pp), which increased by 6.9%. The groundwork for investment growth was laid by the achievement of macroeconomic stability, significant

Chart III.8.1 **Contribution to annual GDP growth rate − expenditure side**
(pp)



Sources: SORS and NBS calculation.

[22] General government debt includes debt of central government and non-guaranteed debt of local government.

[23] At end-2015 debt of central government stood at EUR 24.8 bln or 75.9% of GDP.

improvement of business and investment environment following the adoption of systemic laws in the area of labour and construction and lowering of costs of doing business owing to more favourable borrowing terms and low energy prices. Investment growth was confirmed both by movement of construction indicators and high increase in imports of equipment and domestic production of machinery and equipment. The growth of investment activity was financed by an inflow of FDI which grew by 46% in the year under review and reached EUR 1.8 bln. In addition, new investment loans rose in 2015 by as much as 150.0%.

Fiscal consolidation measures reflected mostly on **final government consumption**, which dropped by 1.2%, giving a negative contribution to GDP of 0.2 pp. A 10.0% reduction in public sector wages enforced in November 2014 pushed wage expenditure down by 9.8% in real terms in 2015. Austerity measures also had a bearing on the second component of government final consumption, with outlays for the purchase of goods and services going down by 1.1%.

Similarly to private, **government investment** also increased in real terms in 2015 (17.0%), giving a 0.4 pp positive contribution to GDP. A particularly strong upswing in this component was recorded as of H2, which is associated with accelerated implementation of a number of infrastructure projects. This is also signalled by the movement of consolidated government capital expenditure, which went up by 30% in H2 relative to H1.

Table III.8.1 **Investment indicators in 2015**
(y-o-y growth rates, in %)

Construction sector (national accounts)	11.1
Number of issued construction permits	26.3
Production of construction material	3.0
Value of works done (territory of Serbia)	18.3
of which: - buildings	12.4
- other (infrastructure)	20.4
Gross fixed capital formation (national accounts)	8.3
Imports of equipment	11.7
Production of machinery and equipment	19.1
Repair and installation of machinery and equipment	6.6

Sources: SORS and NBS calculation.

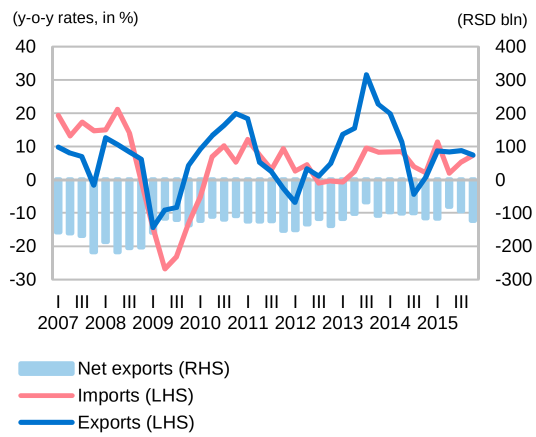
Net external demand

A recovery of external demand prompted by faster growth of the euro area reflected positively on domestic exports of goods and services, which accelerated their growth to 7.8% in real terms in 2015 (5.7% in 2014). On the other hand, growth of real imports of goods and services (5.5%) remained broadly unchanged from 2014, since lower imports of energy were compensated for by increased imports of equipment. Such trends resulted in a positive contribution of net exports to GDP of 0.3 pp in 2015.

In 2015, a positive impetus to domestic exports from external demand was signalled by the rise of indicator of external demand for Serbian exports[24], which upped by 2.2% in annual terms. This was aided by a gradual recovery of economic confidence in the euro area and acceleration of its economic growth.

In 2015, euro-denominated commodity exports recorded a growth of 7.9% y-o-y, dispersed across almost all areas of manufacturing (20 of 23 branches[25]). The growth was mainly driven by higher exports of agricultural and food products as well as metal complex products (base metals, metal products and machinery and equipment). Also, a

Chart III.8.2 **Exports and imports of goods and services**
(in previous-year constant prices, ref. 2010)

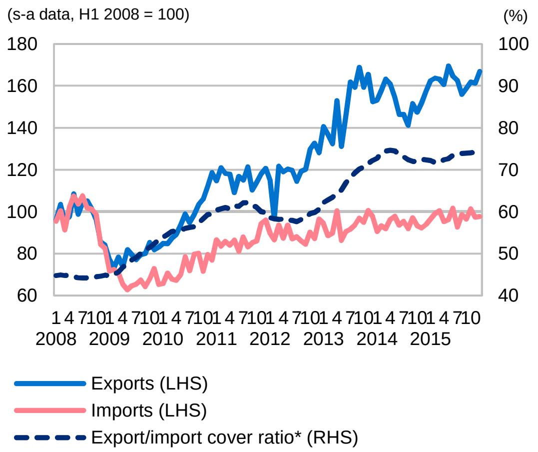


Sources: SORS and NBS calculation.

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

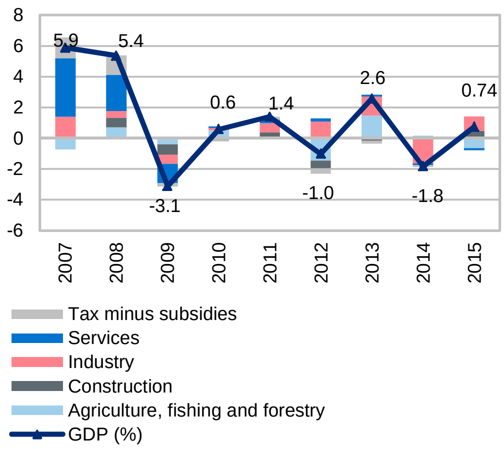
[25] According to the classification, manufacturing comprises 24 branches, but repair and installation of equipment is not included in commodity exports.

Chart III.8.3 **Commodity trade in euros**



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

Chart III.9.1 **Contributions to annual GDP growth rate – production side**
(pp)



Sources: SORS and NBS calculation.

relatively sizeable growth was recorded for exports of rubber and plastic products, tobacco products and pharmaceutical products and preparations. On the other hand, exports of motor vehicles and petroleum products, which had been the main drivers of export growth in 2013 in 2014, recorded a drop in 2015.

In 2015, commodity exports grew by 5.8% y-o-y in euro terms, mostly on the back of imports of equipment driven by intensified investment activity. The greatest fall in exports was recorded for energy, due to a decline in energy product prices (oil and natural gas) in the global market.

With commodity exports growing faster than imports, indicators of commodity trade improved, given that in December 2015 commodity export/import cover ratio reached 74.2%, up by 1.8 pp relative to the same period the year before.

9 Economic activity

In 2015, economic activity was marked by a recovery in industrial production and a strong growth of construction industry. These two sectors were the main drivers of GDP growth, which in annual terms equalled 0.74%. On the other hand, the fall was recorded in agricultural production, as well as in some service sectors.

In quarterly terms, GDP contracted only in Q1 (1.8% y-o-y) due to the base effect, and the fact that the mining-energy complex had not fully recovered from flooding. Its recovery in Q2 boosted GDP growth (1.1% y-o-y), which continued for the remainder of the year (2.3% y-o-y in Q3 and 1.2% y-o-y in Q4).

Owing to the recovery of external demand and recuperation of the mining-energy complex from the effects of May 2014 flooding, industrial production recorded an increase in gross value added of 4.7% in 2015. The sector of electricity, gas and steam supply expanded the most (15.7%), owing to the modernization of production capacities as part of flood remediation efforts. Somewhat lower growth was recorded in mining (10.0%), mostly on account of recovery of coal production, while the exploitation of crude oil and metal ores shrunk as a result of a decline in global market prices.

The gross value added increased also in manufacturing (3.0%), prompted both by faster growth in the euro area which fuelled external demand and a drop in prices of energy products and other primary commodities in the global market, which, coupled with lower costs of borrowing, reduced the costs of doing business. Physical volume of production in this sector expanded by 5.3% and growth was recorded in 18 of the 24 branches. Positive trends in the global steel market in place since

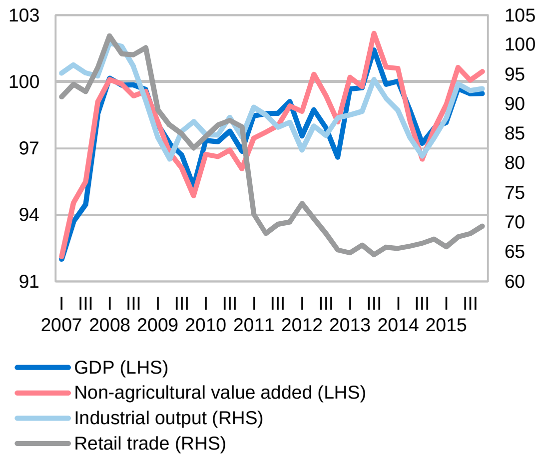
H2 2014 triggered the re-launch of production in Smederevo Steel Plant, which pushed the base metal production up by 20.6%, and contributed to the recovery of production in the remaining segments of the metal complex as well (production of metal products and machinery and equipment). Chemical industry production bounced back as well, benefiting from a drop in natural gas prices. Other branches with high export potential also recovered – production of rubber and plastic products, pharmaceutical and tobacco industry. On the other hand, production of motor vehicles, other means of transport and computers recorded a decline.

Apart from industry, a positive contribution to GDP growth in 2015 came also from **construction**, whose gross value added increased by 11.1%. This was supported by improved legislation in the sector, which speeded up the issuance of construction permits and facilitated the acquisition of ownership of construction land, which used to be the main obstacles to stronger growth of this sector. All construction indicators signalled growth of the construction industry. The value of works performed grew in real terms by 18.3%, the number of workers on construction sites went up by 2.3%, while effective hours worked increased by 2.9%. The number of construction permits issued also rose considerably (26.3%), and the production of construction material went up by 3.0%.

A wave of hot weather in July unfavourably impacted corn and industrial plant yields, pushing gross **agricultural** value added down by 7.5%. Corn output shrunk by 30% relative to 2014, and production of industrial plants declined by around 20%. On the other hand, positive trends were recorded in vine growing, which expanded by 40%, as well as in fruit and vegetable growing and wheat production, which were not significantly affected by drought. Based on indicator movements, it is estimated that cattle breeding also recorded a mild increase, aided by low prices of animal feed in the global market.

The service sectors practically stagnated in 2015 (gross value added declined by 0.2%). A mild upswing in activity was recorded in trade, transport, storage and food and accommodation services, as signalled by main indicator movements. In 2015, retail trade turnover upped by 2.2% in real terms, while indices of physical volume in

Chart III.9.2 **Economic activity indicators**
(s-a, H1 2008 = 100)



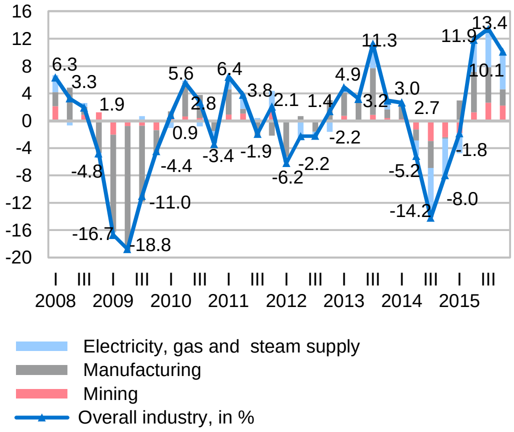
Sources: SORS and NBS calculation.

Table III.9.1 **Economic activity in 2015**

	Growth rates (%)	Contribution to GDP growth (pp)
Gross domestic product (GDP)	**0.74**	**0.74**
Agriculture, forestry and fishing	-7.5	-0.7
Industry	4.7	0.9
Construction	11.1	0.5
Wholesale and retail trade; repair of motor vehicles and trailers, transportation and storage, accomodation and food services	0.7	0.1
Information and communication	-0.4	0.0
Financial and insurance activities	2.2	0.1
Real estate activities	-0.6	-0.1
Professional, scientific and technical activities, administrative and support service activities	-0.3	0.0
Public administration and compulsory social security; education, human health and social work activities	-1.3	-0.2
Arts, entertainment and recreation, other service activities and activities of households as employers;	-1.4	0.0
Gross value added (GVA)	0.9	0.8
Net taxes	-0.2	0.0

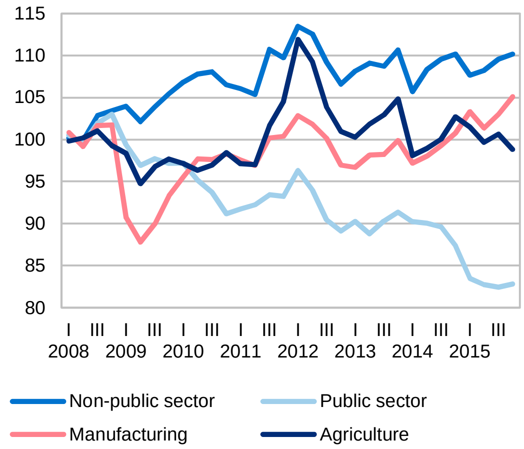
Sources: SORS and NBS calculation.

Chart III.9.3 **Contributions to y-o-y growth of the volume of industrial production**
(in pp)



Sources: SORS and NBS calculation.

Chart III.10.1 **Real net wages**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

passenger and freight transport increased by 6.7% and 7.1%, respectively. Catering turnover index also increased (1.9%), as well as tourist arrivals (11.2%) and overnight stays (9.3%). Growth was also recorded in the sector of financial services. Other service sectors experienced a decline, most pronounced in public administration, education, health care and social protection.

10 Wages and employment

In 2015, real net wage declined for the third consecutive year (2.1%). The decline was largely prompted by fiscal consolidation measures, i.e. 10.0% cut in public sector wages enacted in November 2014. This was confirmed by the fact that lower real wage resulted from a decline in public sector wages (7.2%), while real net wage outside the public sector even increased mildly, by 0.4%. Growth in non-public sector wages was supported by the recovery of economic activity. Such trends prompted further narrowing of the wage gap between public and non-public sector wages by 0.8 pp in 2015, to 5.3% in December. Average monthly nominal net wage in 2015 stood at RSD 44,432, almost unchanged from 2014.

Observed by activity, a relatively high growth of real net wage was recorded in construction, manufacturing, information and communication, and food and accommodation services, i.e. in areas dominated by the private sector, and may be associated with the recovery of economic activity in these sectors. A somewhat milder growth of real wage was recorded in trade, mining and financial sector. On the other hand, the cut in public sector wages affected real wages in sectors where government holds a dominant share. So the real wage declined the most in public administration, education, health care and social protection, arts, entertainment and recreation, as well as in electricity, gas and steam supply.

The year 2015 also saw an improvement in cost competitiveness measured by unit labour costs, which at the level of the overall industry dropped by 2.6% relative to 2014. This was mostly owing to the recovery of industrial production from the consequences of the 2014 flooding, given that the increase in productivity (6.6%) surpassed the growth in real gross wages (4.0%). Productivity growth was also recorded in manufacturing (2.8%), but since this sector saw a considerable increase in real gross wage (6.8%), unit labour costs went up.

The recovery of economic activity led to an improvement in the labour market in 2015. According to the Labour Force Survey, the average employment rate inched up by 0.5 pp to 42.5%, hand in hand with an increase in participation rate[26] (by 0.3 pp to 63.6%) and a decline in informal employment. Employment increased in sectors which were the main drivers of economic growth – industry and construction and, to a lesser extent, service sectors. On the other hand, agricultural employment

[26] Measured as a share of active (employed and unemployed) persons in the total working age population (aged 15-64).

dropped due to an underperforming agricultural season. The number of full time employees increased, while the number of part-time employees went down. Observed by type of contract, an increase in employment was recorded for fixed-term contracts, owing to changes in labour legislation which extended the maximum term of such contracts from one to two years. These amendments, together with the strengthening of inspection, were also conducive to curbing grey economy in the labour market. This is indicated both by a drop in informal employment and the smaller number of employees in unregistered private property.

Apart from employment growth, 2015 witnessed also a drop in average unemployment rate, by 1.5 pp to 17.7%. Unemployment of youth (aged 15-24) declined on average by 3.4 pp to 43.2%, and long-term unemployment[27] also improved, as its share in total unemployment declined on average by 2.6 pp.

Improved situation in the labour market is confirmed also by data from other sources. According to data from the Central Registry of mandatory social insurance, formal employment inched up by 0.4% y-o-y in December 2015. The growth was recorded for private entrepreneurs and their employees, while the number of individual agricultural producers went down. Employment in legal entities which comprise a bulk of the labour force remained almost unchanged.

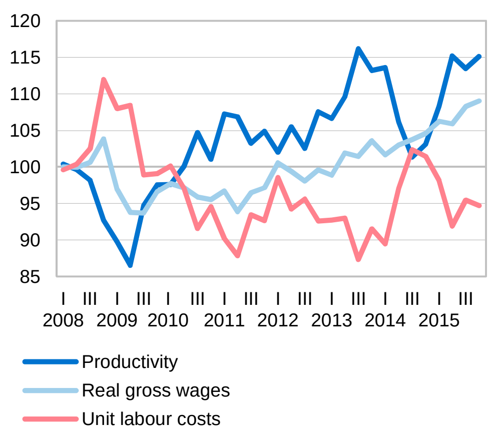
The fall in unemployment is also confirmed by the National Employment Agency data for December 2015, which shows that the number of unemployed declined by 17,810 persons relative to a year before. Lower unemployment is recorded in almost all groups of professions, except in some of those related with the public sector (health care and social protection, culture, arts and public information). The fall in unemployment reflected also on the number of recipients of unemployment benefit, which declined by 10,573 persons y-o-y, to 45,162 in December 2015.

Table III.10.1 **Formal employment and unemployment trends**
(quarterly growth rates, end-of-period)

	2015			
	Q1	Q2	Q3	Q4
Total number of formally employed	0.1	0.4	0.9	-1.0
Employed with legal persons	0.1	0.2	0.8	-1.2
Entrepreneurs and their employees	0.0	2.0	2.0	0.6
Individual farmers	-0.8	-1.0	-1.2	-1.0
Unemployed persons	3.3	-2.7	-1.3	-1.6
First-time job seekers	1.2	-2.7	-1.1	-1.7
Used to be employed	4.4	-2.7	-1.5	-1.6

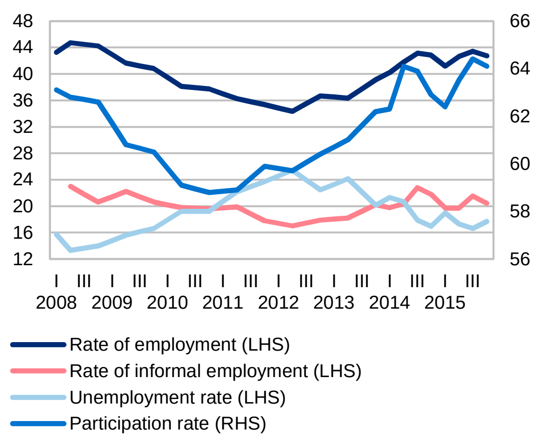
Sources: SORS and National Employment Service.

Chart III.10.2 **Productivity, real gross wages and unit labour costs in industry**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Chart III.10.3 **Labour market indicators under the Labour Force Survey**
(in %)



Source: SORS.

[27] Job seekers for longer than one year.

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

NATIONAL BANK OF SERBIA
GOVERNOR
GO. No 943/1/15

Belgrade, 19 March 2015

GOVERNMENT OF THE REPUBLIC OF SERBIA
Mr Aleksandar Vučić, Prime Minister

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), I am writing this letter to inform you that consumer price growth equalled 0.8% in February, which was the sixth consecutive month of inflation moving below the lower bound of the target tolerance band (4.0±1.5%), after the letter we had sent in September 2014 in order to explain the reasons for the undershooting. This letter explains why inflation has moved away from the target tolerance band, describes the measures that will be taken with a view to bringing back and maintaining inflation within the target tolerance band in the medium term, and sets out the period within which we expect inflation to return within the band.

The Executive Board of the National Bank of Serbia assesses that inflation was moving below the lower bound of the target tolerance band from September 2014 to February 2015 mainly on account of temporary factors – the absence of administered price growth and the fall in global oil prices.

The expectations that inflation would return within the target tolerance band by late 2014, which we expressed in the letter of September 2014, were based on the assumption of a 15% adjustment in electricity prices (contribution to inflation: +0.75 pp), which did not materialise. Had the adjustment taken place, inflation would have returned within the target tolerance band by late 2014. This reflected, among other things, on overall movements in administered prices. Namely, year-on-year growth in administered prices fell from 3.5% (in September 2014) to -2.3% (in February 2015), contributing to a 1.2 pp decline in inflation in that period.

Moreover, a vigorous fall in global oil prices in the second half of 2014 resulted in lower prices of petroleum products, dragging inflation down by additional 0.5 pp from September to February. Please note that low inflation is not specific to Serbia only. In early 2015 the majority of European countries recorded negative inflation rates, i.e. deflation.

The National Bank of Serbia has taken measures within its remit to bring inflation back within the target tolerance band in the medium run. Monetary policy easing started back in May 2013. Since then, the key policy rate has been cut from 11.75% to 7.50%, while the weighted average rate on one-week repo operations of the National Bank of Serbia has been moving around 6%. Furthermore, to encourage credit activity and, indirectly, economic activity, the rate of FX required reserve allocations was cut in November, December and January.

Cautious monetary policy easing in the past period was mandated also by risks emanating from the international environment (geopolitical tensions and volatility of international capital flows).

Following the historical low recorded in January, which was due mainly to high last year's base caused by higher VAT and excise rates, year-on-year inflation began to rise in February 2015. We expect inflation to return within the target tolerance band (4.0±1.5%) in the second half of the year. Inflation's return will be supported not only by monetary policy easing, but also by the expected adjustment of electricity prices and the waning effect of the fall in primary commodity prices.

As so far, in pursuing monetary policy objectives, the National Bank of Serbia will act responsibly, will be open to the public 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

Appendix 2 National Bank of Serbia's Letter to the Government of the Republic of Serbia on Reasons Why Inflation Departed from the Target

NATIONAL BANK OF SERBIA
GOVERNOR
GO. No 943/2/15

Belgrade, 15 September 2015

GOVERNMENT OF THE REPUBLIC OF SERBIA
Mr Aleksandar Vučić, Prime Minister[1]

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), I am writing this open letter to inform you that consumer price growth in August equalled 2.1% year-on-year. This was the sixth consecutive month of inflation moving below the lower bound of the target tolerance band (4.0±1.5%), since March 2015 when the previous open letter was addressed to you in an effort to explain the reasons for the undershooting. This letter explains why inflation has moved away from the target tolerance band, describes the policy action that has and will be taken with a view to bringing back and maintaining inflation within the target tolerance band in the medium term, and sets out the horizon over which we expect inflation to return within the band.

In our letter of March 2015 we expressed our expectation that in the latter half of the year inflation would return within the target tolerance band on the back of past monetary measures and the anticipated adjustment in administered prices, assuming as well the waning of the effect of the drop in prices of primary commodities. However, the movement in international primary commodity prices, notably the collapse of oil prices from July 2015, perpetuated the disinflationary role of primary commodities into the second half of 2015. The unusually sharp fall in fruit and vegetable prices (especially in July) caused inflation to be 0.4 pp lower than initially projected for the period March–August 2015. Also, due to the adjustment of electricity prices, the year-on-year administered price growth re-entered the positive territory in August, which is later than we expected.

The National Bank of Serbia has taken measures within its remit in order to bring inflation back within the target tolerance band in the medium run.

As the key policy rate has been cut since March by 300 bp to 5%, the weighted average interest rate on one-week repo operations of the National Bank of Serbia is now revolving around 3.5%. The reduction of the key policy rate has also been accompanied by the fall in interest rates in the credit and interbank money markets. In its last meeting held on 10 September 2015, the National Bank of Serbia's Executive Board decided to cut FX reserve requirement ratio by one percentage point in each of the next six months. Significant FX and dinar funds will be released to banks in this way, which will enable further lowering of lending rates, support credit activity and reflect positively on the pace of economic recovery.

Successful implementation of fiscal consolidation measures and the arrangement with the International Monetary Fund facilitated monetary policy easing and led to the narrowing of internal and external imbalances and improved investment environment.

In view of the expected effects of its monetary policy measures, the National Bank of Serbia judges that year-on-year inflation will be moving around the lower bound of the target tolerance band (2.5%) over the coming twelve months. There is however a possibility that inflation will enter the band late this year or early next year. We expect inflation will steadily trend closer to the 4% target from mid-2016, and this expectation is also shared by the financial market and businesses.

As so far, the National Bank of Serbia will continue to act responsibly and consistently in pursuing monetary policy objectives, thereby contributing to macroeconomic stability and economic growth.

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

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