ANNUAL MONETARY POLICY REPORT

National Bank of Serbia

2017

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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 2017 was adopted by the NBS Executive Board at its meeting of 14 June 2018.

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

Executive Board of the National Bank of Serbia:

Jorgovanka Tabaković, PhD, Governor

Veselin Pješčić, MA, Vice Governor

Diana Dragutinović, PhD, Vice Governor

Željko Jović, PhD, Vice Governor

[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 – Constitutional Court decision NS 44/2018).

[2] RS Official Gazette, Nos 12/2013, 18/2015 and 72/2015.

ABBREVIATIONS

bn – billion
bp – basis point
CEFTA – Central European Free Trade Agreement
CPI – Consumer Price Index
EBRD – European Bank for Reconstruction and Development
ECB – European Central Bank
EMBI – Emerging Markets Bond Index
FDI – foreign direct investment
Fed – Federal Reserve System
GDP – Gross Domestic Product
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
mn – million
NAVA – non-agricultural value added
NPL – non-performing loan
Q – quarter
pp – percentage point
q-o-q – quarter-on-quarter
s-a – seasonally-adjusted
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Contents

Overview

Inflation moved within the target tolerance band of 3.0±1.5% throughout 2017. Its movement early in the year was driven by the recovery of global oil prices since H2 2016, and the impact of extremely cold weather, which pushed up the prices of fruit, vegetables and firewood more than is usual for the season. Having reached 4% in April, as a result of the one-off price hikes of a small number of products and services, y-o-y inflation started to decline in May, stabilising in H2 at around the 3.0% target, this being its average value in 2017. Low inflationary pressures were also indicated by core inflation, which moved around the lower bound of the target tolerance band throughout 2017. In December, core inflation stood at 1.3%, its (then) lowest level since measured by CPI. Subdued inflationary pressures were also confirmed by inflation expectations of financial and corporate sectors which are anchored within the NBS target tolerance band.

Ensuring that inflation is within the new, lower target band, further improvement in the macroeconomic performance and outlook of the country, as well as anchored inflation expectations indicate that the decision to lower the inflation target, made in November 2016, by 1 pp, to 3.0±1.5% starting from 2017, was well-calibrated and timely.

Monetary policy easing continued during 2017. The key policy rate was lowered at a cautious pace – in September and October it was brought down by 25 basis points, each, to 3.5%. In this way, since May 2013, when the cycle of monetary policy easing was set in train, by end-2017 the key policy rate was cut by total 825 basis points. Low inflationary pressures on account of majority of factors from the domestic and international environment and the resulting lower medium-term inflation projection made room for further monetary policy easing and additional support to lending activity and economic growth.

The international environment was characterised by economic growth acceleration in the euro area and Central and Eastern European countries. In addition to robust domestic demand, this was a result of more favourable global growth outlook, which was constantly revised upwards throughout the year. Even though global inflation was somewhat higher than in 2016, faster economic growth did not spur stronger inflationary pressures. The divergence between monetary policies of the leading central banks, the Fed and ECB was an important factor from the international environment guiding the NBS to conduct prudent monetary policy. The possibility for such a global environment to cause sudden shifts in the capital flows towards emerging economies, including Serbia, called for caution. However, the Executive Board was aware that, owing to strengthened domestic macroeconomic fundamentals and improved macroeconomic outlook of the country, Serbia is today more resilient to potentially adverse effects from the international environment. This is also testified by a considerable fall in Serbia's risk premium (which was more pronounced than in the case of emerging economies of the world and Europe), as well as upgraded credit rating by all three rating agencies monitoring Serbia, and successfully completed reviews of the IMF stand-by arrangement.

The NBS monetary policy easing, a fall in the country risk premium and strengthened interbank competition, coupled with low interest rates in the euro area reflected on the further reduction of the borrowing costs of the private sector. At the same time, interest rates on all types of dinar loans to corporates sank to new lows at year-end. Coupled with economic acceleration and positive labour market trends, this continued to reflect favourably on lending activity. Despite the stepped-up efforts to resolve the NPL issue, which resulted in a considerable write-off of corporate and household loans in the amount of RSD 102 bn in 2017, corporate and household lending growth, excluding the exchange rate effect, accelerated to 7.3%.

Real GDP growth in 2017 stood at 1.9% and was primarily driven by the continued positive tendencies in manufacturing and more intense activity in the service sectors. With the gradual waning of the effects of shocks on the supply side, which affected the fall in production, primarily agriculture and energy, economic growth expectedly accelerated in H2, with the contribution from the recovery of construction, as well. Excluding agriculture and energy sectors, that is, areas affected by the mentioned shocks, GDP growth in 2017 stood at around 3%. The increase in the physical volume of manufacturing remained widely dispersed in 2017 (considering that it was recorded in 19 out of 24 areas) and was at 6.3%. Persistent favourable tendencies in manufacturing were on account of earlier investment and lower costs of borrowing, on the supply side. Faster growth in the euro area and growth of other important foreign trade partners were the demand-side factors.

On the expenditure side, GDP growth was led by domestic demand. Preserved macroeconomic stability, continued improvement of the business environment (as confirmed by Serbia's further progress on the World Bank's Global Competitiveness list to the 43rd position out of 190 countries), implementation of infrastructure projects and low costs of financing contributed to rising investment. At the same time, favourable labour market trends kept on having a positive effect on the recovery of household consumption. Exports also continued to record high and dispersed growth. Due to a faster rise in imports, primarily of equipment and intermediate goods for industrial purposes, which is linked with the investment cycle, the contribution of net exports to GDP was negative.

In 2017 the current account deficit equalled 5.7% of GDP. The trade in goods deficit was higher compared to last year's, partly due to greater energy imports, driven by higher needs of the industry, and partly to the rise in global oil prices. In addition, investment growth spurred by the robust FDI inflow pushed up the imports of equipment. In 2017 total commodity exports had two-digit growth, with the rise in manufacturing exports accelerating further (from 11.6% in 2016 to 13.6% in 2017). As expected in the situation of higher FDI inflows relative to 2016, the primary income deficit also went up, the rise being largely neutralised with a higher surplus in the secondary income account and surplus in the trade in services. Rising surplus in the trade in services is a result of the persistent trend of a considerable increase in their exports (14.6% in the last year), particularly in telecommunications, computer and information services. Movements in the financial account were favourable in 2017, especially in terms of FDI. Owing to improved business climate, net FDI inflow in 2017 was higher than EUR 2.4 bn (gross inflow amounted to around EUR 2.6 bn), providing for more than the full coverage of the current account deficit (with 115.6%) for the third year in a row. Despite the maturity of the eurobond issued in the international market in 2012, on which basis non-residents were paid EUR 570 mn, net outflow of portfolio investment was lower compared to 2016. At the same time, other investment account recorded a net inflow, and banks' net foreign borrowing on account of financial loans rose for the first time since 2010. The above movements resulted in the annual rise in FX reserves, by around EUR 228 mn, according to the balance of payments methodology.

Serbia's FX reserves remained at an adequate level for ensuring the protection against external risks – at end-2017 they stood at EUR 9,961.7 mn, which provides for more than five-month coverage of imports of goods and services and 234.1% of foreign debt due next year.

In 2017, fiscal trends were significantly more favourable than expected – for the first time since 2005, surplus was achieved, at the consolidated level of RSD 52.3 bn, or 1.2% of GDP. Excluding interest expenses, the surplus equalled 3.9% of GDP. Continued positive fiscal trends in 2017 were mostly driven by the rise in domestic demand and better performance of companies, labour market recovery and more efficient tax collection. As a result, in 2017 total revenue increased by 4.0%, in real terms. In parallel, total expenses were cut by 1.7%, in real terms, with significant contribution coming from the fall in interest expenses. Interest expenses fell amid decreasing government need for borrowing and lower borrowing price, driven by the NBS monetary policy easing and the fall in country risk premium. Positive fiscal trends and the maturity of the eurobond issued in 2012, in the amount of RSD 750 mn, enabled the downward trend of the public debt share in GDP, initiated in 2016, to continue at an accelerated pace – the share of public debt in projected GDP in 2017 was cut by 10.4 pp, to 61.5%.

The NBS demonstrated uninterrupted commitment to NPL resolution and in 2017 it undertook additional regulatory activities in this area. Previously, in 2016, it had implemented all the activities set forth by the Action Plan for the Implementation of the NPL Resolution Strategy. Undertaken measures and activities more than halved the level of NPLs in the past two years, which, coupled with macroeconomic stability effects and expanded lending activity, brought about the lowering of their share in total loans below the pre-crisis level. Based on these factors, the share of NPLs was reduced at end-2017, to 9.8%, down by 12.5 pp compared to the inception of the Strategy implementation.

In 2017, the NBS continued to implement activities aimed at promoting the use of the dinar in the Serbian financial system. These measures, along with the results achieved in the field of macroeconomic stability, mainly through ensured and preserved price stability and relative stability of the exchange rate, contributed to a further rise in the degree of dinarisation of both loans (to 33.0%) and deposits (to 30.8%).

Maintaining low and stable inflation in the medium run and preservation of financial stability remain the main tasks of the NBS, that being the best way for a central bank to contribute to economic prosperity of the country.

I Strategic monetary policy framework

The NBS has been implementing a **fully-fledged inflation targeting regime** since early 2009, with elements of the regime gradually introduced into practice since 2006. In December 2008, the NBS Monetary Policy Committee[1] adopted the Memorandum on Inflation Targeting as a Monetary Strategy, formally defining implementation of the inflation targeting regime from 1 January 2009. The Memorandum was drafted in accordance with the Agreement on Inflation Targeting between the NBS 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 for Serbia under the circumstances prevailing at the time.

The inflation targeting regime is pursued by a significant number of central banks worldwide as a pragmatic response to deficiencies of other monetary policy regimes. The choice of the regime was strengthened by the awareness that high rates of inflation dampen 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. More of a framework than a set of rigid monetary policy rules, this regime 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 NBS inflation target 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). The target is determined as a midpoint with a tolerance band.

Low and stable inflation for three years in a row and significant improvement in macroeconomic fundamentals and prospects of our economy going forward, supported by successful coordination between monetary and fiscal policies and excellent results of fiscal consolidation, led to the NBS making the decision in November 2016, in cooperation with the Government, to **lower the inflation target by 1 pp to 3.0±1.5% starting from 2017.**[2] In order to define the framework for medium-term monetary policy decision-making and to anchor and stabilise inflation expectations, one year later a decision was made to keep the target at that level until 2020.[3]

An important reason for lowering the inflation target from 2017 onwards were inflation expectations of the financial and corporate sectors, both one and two years ahead, that had been low and relatively stable for quite a while already. At the same time, this served as a confirmation of greater credibility of the NBS monetary policy. In addition, administered price growth in the last three years was much slower than before. Given that the change was the result of the Government's commitment to resolving the inefficiencies in the operation of public enterprises primarily by reducing operating costs, rather than by raising the prices of goods and services of those enterprises, it was concluded that administered price growth should remain relatively low in the period ahead.

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

[2] The National Bank of Serbia's Memorandum on Inflation Targets until 2018 (consolidated version).

[3] The National Bank of Serbia's Memorandum on Inflation Targets until 2020 was adopted at the meeting of the NBS Executive Board of 7 December 2017.

The lowering of the target confirms the commitment of economic policy makers to keeping inflation low, stable and predictable in the medium-term. This contributes to the further improvement of the business and investment climate, encourages a fall in long-term dinar interest rates and greater use of the dinar in financial transactions and, by extension, helps lower the currency risk and costs borne by the corporate, household and government sectors. In addition, the new, lower inflation target still remains above the level of the quantitative definition of price stability and the level of the inflation target in advanced economies (2.0% or 2.5%), leaving room for further price convergence.

The width of the target tolerance band was kept at ±1.5 pp, which diminishes the need for frequent monetary policy interventions and contributes to higher predictability of monetary conditions. Being a small and open economy, Serbia is exposed to developments in the international commodity and financial markets, which may cause **temporary** volatility of headline inflation. The target band leaves to the NSB a broader room to work on the achievement of its second objective – financial stability, and to support the Government's economic policy, which encourages sustainable economic growth.

It should also be borne in mind that the inflation target is a medium-term objective, i.e. that the inflation outturn may diverge from the target in the short run due to exogenous shocks. The National Bank of Serbia will allow temporary deviations from the target if bringing inflation back to the target in the short term warrants monetary policy changes that would cause additional disruptions to macroeconomic processes. This also applies to sudden changes in primary commodity prices or deviations from the planned growth in product prices under direct or indirect government regulation.

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

The NBS is implementing a **managed float exchange rate regime**, which implies the right to intervene in case of excessive short-term volatility in the FX market, threats to financial and price stability, and risks to the adequate level of FX reserves.

To strengthen the transparency of its monetary policy and the effectiveness of communication with the public, the NBS Executive Board makes 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.

Ensuring the movement of inflation within the new, lower target band, the further improvement in the macroeconomic performance and outlook of the country, and anchored inflation expectations show that the decision to lower the inflation target, made in November 2016, by 1 pp to 3.0±1.5% starting from 2017 was well-calibrated and timely.

II Monetary policy and achievement of the inflation target

1 Monetary policy in 2017

In 2017, monetary policy was pursued in accordance with the **Monetary Policy Programme of the National Bank of Serbia in 2017**.[4] As envisaged by the Programme, the NBS achieved the inflation target of 3.0±1.5%, carefully monitoring the trends in the domestic and international environment, i.e. international financial and primary commodity markets. The NBS maintained flexibility in using monetary policy instruments, bearing in mind the expected effects of past monetary policy easing on inflation movements and acknowledging uncertainties in the global capital market.

The key policy rate – the NBS main monetary policy instrument – **was kept on hold (4.0%) from January to September 2017**. The Executive Board decided to keep the rate on hold taking into account expected inflation movements in the medium term and its key underlying factors, the effects of past monetary policy easing and a lower inflation target.

In the January–September period, the Executive Board highlighted that inflation would remain low and stable, moving within the target tolerance band of 3.0±1.5% throughout 2017 and thereafter. As assessed by the Board, until the year-end, inflation would be under the impact of the low base for fruit and vegetable prices, a gradual rise in aggregate demand in Serbia and inflation in the international environment. Inflation would for some time yet be slowed by low costs of raw materials in food production, and a high base for petroleum product prices as of March. Persistent low inflationary pressures on account of most factors from the domestic and international environment, along with the effects of a higher base for products and services whose prices recorded one-off hikes in early 2017, would drag down on inflation as of early 2018. That inflationary pressures remained low was also confirmed by stable core inflation, moving at around 2% y-o-y. In addition, low inflationary pressures were reflected in anchored inflation expectations – the financial and corporate sectors stated that price stability would be preserved both in the short and medium term.

A good agricultural season in 2016 prompted a fall in fruit and vegetable prices, which were expected to rise assuming an average agricultural season in 2017. However, due to extremely cold weather in early 2017, their rise was higher than usual for the season. Besides, because of the drought during the summer months, expectations increased that the prices of primary commodities and fruit and vegetables could be at a higher than seasonally expected level in the remainder of the year, which could have second-round effects on other prices.

According to the Executive Board assessment, gradual recovery of domestic demand was aided by rising wages and employment in the private sector, as well as past monetary policy easing. Interest rates in the domestic market continued down, while much more favourable terms of funding contributed to growth in lending activity and investment.

In addition to domestic demand, the Executive Board expected external demand to recover as well. Following

[4] RS Official Gazette, No 98/2016.

slow global economic recovery in the past years, the economies of the majority of countries and international trade showed signs of more visible recovery. A brighter euro area growth outlook was expected to positively reflect on other countries in the region, which are also our important trade partners. In addition, after picking up in early 2017 due to higher energy and food prices, euro area inflation stabilised at a somewhat higher level than the year before, though still remaining below the target.

The conduct of monetary policy in the period observed mandated caution also because of uncertainties in the international financial market over increased divergence of monetary policies of leading central banks. The Fed continued to raise its funds rate, announcing it would start to reduce its balance sheet as of October 2017, i.e. reinvest the due principal of securities purchased during the quantitative easing programme. Caution was needed as such global environment could cause sudden shifts in capital flows towards emerging economies, including Serbia. On the other hand, the ECB continued to implement the quantitative easing programme, which mitigated the negative effects of Fed's monetary policy normalisation. The ECB's moves are particularly important for Serbia, given the financial links and the fact that the euro area is our most important trade partner. However, despite global economic recovery, there were no signs that inflationary pressures were rising on the demand side and that the tightening of monetary policies of leading central banks could be faster than announced.

Analysing new information about economic trends at home and abroad, **in September and October the NBS Executive Board cut the key policy rate by 25 bp each to 3.5%**, its lowest level in the inflation targeting regime. The NBS thus gave additional support to lending activity and economic growth.

As the Executive Board expected, y-o-y inflation and core inflation slowed during the summer. Core inflation fell to 1.5% y-o-y in August, where it stayed in September. However, inflation slowed more than expected as the drought effects on inflation were smaller than assumed. The negative effects of drought on fruit and vegetable prices and prices of primary agricultural commodities in the domestic market were weaker than estimated, while second-round effects were, by all odds, absent. This was indicated by processed food prices, which were broadly unchanged, while both one- and two-year ahead inflation expectations declined further.

Inflation was dampened by lower dinar import prices, including the prices of primary agricultural commodities and oil. In addition, the country risk premium fell to its lowest level on record for Serbia, in an environment of improved domestic fundamentals and under the impact of global factors. The Executive Board's decision to cut the key policy rate in September and October was also supported by fiscal trends, which exceeded expectations, as best confirmed by the budget surplus. This reduced the government's need to borrow, contributing, among other things, to a further reduction in the public debt to GDP ratio. As expected by the Executive Board, fiscal efforts, supported by economic growth, would help public debt decline further in the coming period.

Taking into account past monetary policy easing, the new, November inflation projection, movement in its key underlying factors, better economic performance and outlook going forward, in **November and December** the Executive Board **kept the key policy rate on hold (3.5%)**. It assessed that inflation would move within the target band in the following two years, declining in H1 2018 as a result of the base effect for food and energy prices. Headwinds would come from low cost-push pressures on account of dinar import prices and primary agricultural commodity prices in the domestic market, and a further decline in the country risk premium. Working in the opposite direction were the expected rise in domestic demand (driven by rising wages and employment) and the effects of past monetary policy easing.

Caution in monetary policy conduct was still mandated by developments in the international environment. However, as underlined by the Executive Board, owing to better macroeconomic fundamentals and a favourable outlook going forward, Serbia increased its resilience to potential negative effects from the international environment. The confirmation about further improvement of Serbia's macroeconomic prospects and the results of structural reforms came from Standard & Poor's and Fitch agencies, which upgraded Serbia's credit rating in December. Furthermore, improved macroeconomic prospects were also confirmed by the IMF mission during its reviews of the precautionary arrangement.

In the period ahead, the Executive Board will continue to apply a well-calibrated mix of monetary policy measures aimed at maintaining low and stable inflation, while preserving financial stability and supporting economic growth.

2 Monetary policy instruments

The main monetary policy instrument of the NBS is the **key policy rate, i.e. the interest rate on the main open market operations**. The role of the key policy rate is supported by the **corridor of interest rates on deposit and lending facilities and by other open market operations**. In addition to the key policy rate, the NBS uses other instruments of monetary regulation, notably **reserve requirements and operations in the FX market**.

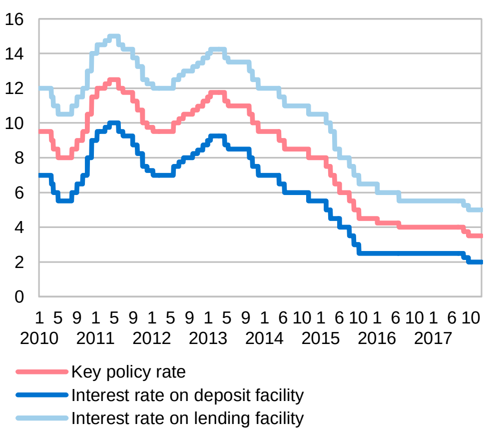
Open market operations

The main open market operations of the NBS in 2017 were again **one-week reverse repo transactions**, i.e. repo sale of securities (liquidity absorbing).

The NBS implemented repo transactions through own securities. For the purposes of repo sale, in 2017 the NBS issued one series of T-bills in the nominal amount of RSD 500.0 bn. The issuing of one series of high nominal value is consistent with the practice in earlier years that enables more adequate management of securities within the same series and facilitates liquidity management for banks.

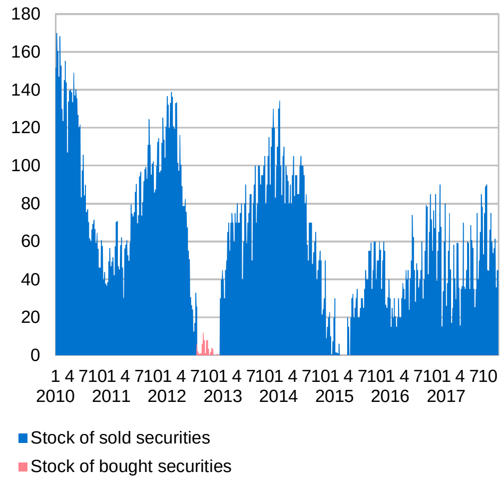
In 2017, fifty-two repo sale auctions were organised once a week **upon the model of the variable multiple interest rate**. The sales totalled RSD 2,701.7 bn, which was somewhat higher than in 2016 (RSD 2,343.4 bn).

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 bn)



Source: NBS.

The stock of NBS bills in banks' portfolios averaged RSD 51.8 bn in 2017, up by RSD 6.8 bn from 2016. Relative to end-2016, the stock of these bills increased by RSD 11.3 bn to RSD 45.1 bn at end-December.

The sales volume was gradually increasing in 2017. Total securities sales amounted to RSD 1,199.9 bn in H1 and RSD 1,501.8 bn in H2.

Deposit and lending facilities

In 2017 banks continued to place overnight deposits with the NBS. The average daily stock of bank deposits with the NBS in 2017 came at RSD 14.8 bn, which is RSD 13.1 bn less than in 2016. The highest average monthly stock was recorded in January (RSD 22.3 bn) and the lowest in July (RSD 8.7 bn).

In 2017, banks rarely used lending facilities, mainly as intraday loans (eight banks), and less as overnight loans (one bank). Intraday loans were worth a total of RSD 61.1 bn, with the peak recorded in Q3 (RSD 23.4 bn). Overnight loans were used less frequently (only in H2) in smaller amounts, totalling RSD 12.6 bn, the most of which related to July (RSD 6.2 bn).

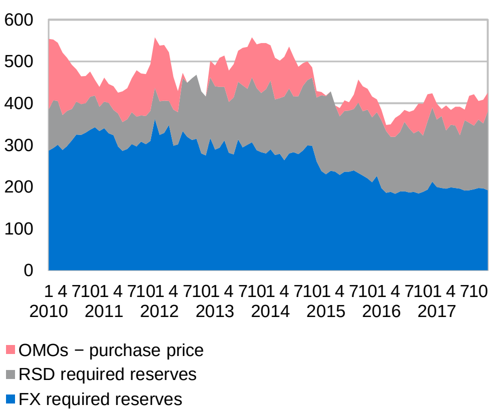
Reserve requirements

The rates and manner of required reserve allocation were not changed in 2017.

At end-2017, calculated required reserves allocated in dinars increased by RSD 8.5 bn relative to end-2016, to RSD 155.8 bn. Of that amount, RSD 1.9 bn related to dinar required reserves and RSD 6.6 bn to dinar allocations of foreign currency required reserves.

In the same period, the amount of calculated required reserves allocated in foreign currency increased by EUR 141.2 mn to EUR 1.7 bn. Such a development resulted from the increase in the foreign currency base by EUR 1.2 bn, in the part of FX liabilities with maturity up to two years. The majority of the increase relates to household FX savings and foreign FX liabilities of banks.

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



Source: NBS.

Foreign exchange market operations

Under the 2017 Monetary Policy Programme, the NBS continued to implement the managed float exchange rate regime. Its interventions in the FX market aimed to ease excessive short-term volatility of the exchange rate, safeguard financial and price stability and maintain an adequate level of FX reserves.

In 2017, the dinar gained 4.2% against the euro in nominal terms, mostly as a result of:

1) improvement of Serbia's macroeconomic indicators and outlook of the domestic economy (contributing to a net FDI inflow more than sufficient to cover the current account deficit);

2) greater interest of foreign portfolio investors in investing in long-term dinar government securities;

3) higher FX inflow during the tourist season and

4) rise in net FX-indexed bank assets.[5]

In 2017, the NBS intervened in the IFEM as a net buyer of EUR 725.0 mn (buying EUR 1,355.0 mn and selling EUR 630.0 mn). The NBS intervened as a price taker, strictly under market conditions.

Depreciation pressures were recorded in the domestic market early in the year, in January and the first ten days of February. They were mostly prompted by heightened uncertainty in the international environment due to diverging monetary policies of the Fed and ECB, especially following the Fed's decision to raise its policy rate in December 2016, and by higher FX demand of domestic energy importing enterprises, usual for the season. The FX market was relatively stable from mid-February. The period from April until mid-November mostly saw appreciation pressures, which resulted from favourable macroeconomic developments and outlook for the domestic economy. Depreciation pressures marked the second half of November and most of December, primarily owing to higher FX demand of domestic energy importing companies, which is usual for the season.

In quarterly terms, in Q1 the dinar lost 0.4% against the euro in nominal terms, and the NBS exclusively sold foreign currency in the IFEM (EUR 345.0 mn). Despite NBS FX purchases in Q2 (EUR 505.0 mn), the dinar strengthened against the euro by 2.6% in nominal terms. In Q3, the dinar's appreciation continued (by 1.2%), whereas the NBS intervened only by purchasing foreign currency (EUR 605.0 mn). Though depreciation pressures strengthened in mid-Q4, in this quarter the dinar strengthened by 0.8%, with net sales in the IFEM (the NBS bought EUR 245.0 mn and sold EUR 285.0 mn).

[5] Aiming to balance their long open foreign currency positions, thus reducing exposure to exchange rate risk, banks sell foreign currency, which results in the strengthening of the dinar.

Foreign exchange swaps

In 2017, the NBS continued to hold its regular three-month and two-week FX swap auctions of FX purchase and sale for dinars, in order to develop interbank swap trading and facilitate more efficient bank liquidity management. In 2017, a total of 102 regular two-week swap auctions were held, with the NBS swap selling and purchasing EUR 363.0 mn. It also held 100 regular three-month swap auctions, at which it swap sold and bought EUR 183.5 mn. The highest performance was recorded in March, when the NBS swap sold and bought EUR 62.0 mn. At end-2017, the stock of FX receivables and FX liabilities of the NBS in respect of three-month swap auctions equalled EUR 32.0 mn each. NBS FX receivables and FX liabilities to banks in respect of two-week swap auctions measured EUR 19.0 mn each.

3 Achievement of inflation target in 2017

Inflation moved in the new, lower target band of 3.0±1.5% throughout 2017. Its movement early in the year was driven by the recovery of global oil prices since H2 2016, and the impact of extremely cold weather, which pushed up the prices of fruit, vegetables and firewood more than is usual for the season. Having reached 4% in April as a result of the above one-off hikes of a small number of products and services, y-o-y inflation started to decline in May, stabilising in H2 around the 3.0% target. The average inflation rate equalled 3% in 2017 as well. Low inflationary pressures were also indicated by core inflation, which moved around the lower bound of the target tolerance band throughout 2017. In December, core inflation stood at 1.3%, its (then) lowest level since it has been measured by CPI.

Inflationary pressures remained low, and the weather (which was extremely cold at the start of the year, followed by drought in the summer) was the dominant driver of inflation in 2017, as indicated by the fact that 1.3 pp of 1.4 pp – the difference between inflation at end-2017 and end-2016 – relates to the rise in the contribution of fruit and vegetables (from -0.4 pp at end-2016 to 0.9 pp at end-2017).

Table II.3.1 **Contribution to y-o-y consumer price growth**
(in pp)

	December 2016	December 2017	Difference
Consumer prices (CPI)	1.6	3.0	1.4
Unprocessed food	0.0	0.9	1.0
Fruit and vegetables	*-0.4*	*0.9*	*1.3*
Fresh meat	*0.3*	*0.0*	*-0.3*
Processed food	0.2	0.4	0.2
Industrial products excluding food and energy	0.5	0.6	0.0
Energy	0.5	0.6	0.1
Firewood	*0.1*	*0.2*	*0.1*
Services	0.4	0.5	0.1

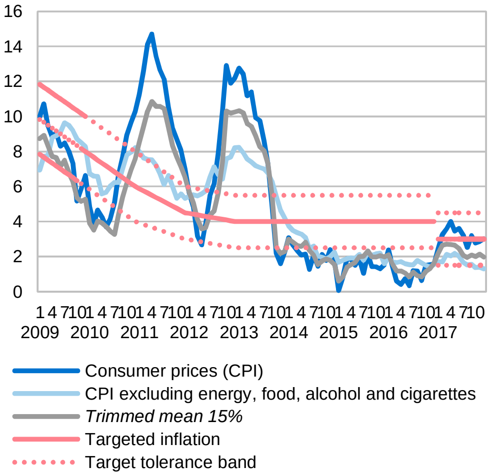
Sources: SORS and NBS calculation.

Overall, **food prices** picked up by 4.2% in 2017 (contributing 1.3 pp to inflation). **Unprocessed food prices** gained the most in 2017 (8.5%), specifically prices of fruit (22.4%) and vegetables (12.9%), mostly because of adverse weather conditions, but also because these prices were extremely low in H2 due to the previous excellent agricultural season. **Processed food prices** rose by 1.9% y-o-y in December, which is why their contribution to headline inflation in 2017 remained low (0.4 pp), primarily owing to the persistent low prices of primary agricultural commodities in the global market. The strongest boost was provided by the prices of non-alcoholic beverages, milk and dairy products, and processed meat products.

Industrial product prices excluding food and energy picked up by 2.0% y-o-y in December, contributing 0.6 pp to inflation. The price growth in this group was predominantly determined by the January and July cigarette price hikes totalling 8.9% (contribution to inflation: 0.4 pp). The dinar's strengthening during the year drove down the prices of imported goods expressed in dinars, as well as rents.

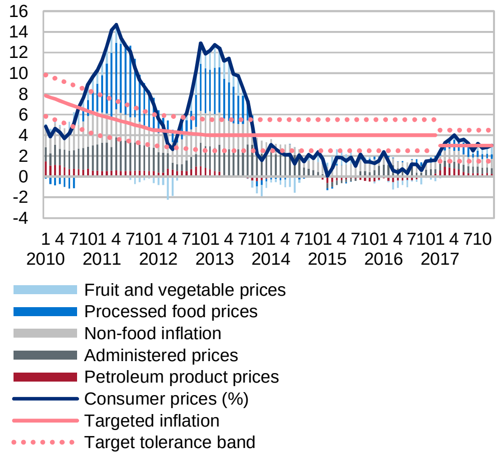
At the annual level, **prices of services** rose by 2.1% (contribution to inflation: 0.5 pp), chiefly due to the March increase in the prices of mobile telephony services of one mobile network operator by 12%, and to higher prices of travel packages by around 13%.

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



Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

Energy prices gained 3.8% in 2017 (contribution to headline inflation: 0.6 pp in December). In this category, prices of petroleum products gave the strongest positive contribution, and were followed by the prices of firewood and electricity. Compared to end-2016, the contribution of electricity prices was lower (electricity prices picked up by 2.1% in 2017, as opposed to 3.8% in 2016), and that of firewood was higher (due to extremely cold weather in early 2017). As regards petroleum products, the largest contribution to y-o-y inflation came in February and March (by 0.9 pp in each month), resulting not only from the low base effect from the same period in 2016, but also from the recovery of global oil prices in late 2016 following the agreement between OPEC countries and Russia on curtailing oil production. As the year progressed, the contribution of petroleum products waned, standing at 0.3 pp at end-2017.

Table II.3.2 **Growth and contribution of components to consumer price growth in 2017**

	Growth rates (%)	Contribution (pp)
Consumer prices (CPI)	**3.0**	**3.0**
Unprocessed food	8.5	0.9
Processed food	1.9	0.4
Industrial products excluding food and energy	2.0	0.6
Energy	3.8	0.6
Services	2.1	0.5
Core inflation indicators		
CPI excluding energy	2.9	2.4
CPI excluding energy and unprocessed food	2.0	1.5
CPI excluding energy, food, alcohol and cigarettes	1.3	0.6
Administered prices	2.9	0.6

Sources: SORS and NBS calculation.

Administered prices, i.e. prices under direct or indirect impact of the Government, grew by 2.9% in 2017, contributing 0.6 pp to headline inflation. The growth in this price group was almost fully determined by hikes in cigarette and electricity prices. Reduced prices of medicines worked in the opposite direction.

Core inflation,[6] as part of CPI under the strongest impact of monetary policy, remained low and stable in 2017. It moved around the lower bound of the target tolerance band, measuring 1.3% y-o-y in December, which is lower than its level a year earlier. Such developments in core inflation indicate that low inflationary pressures are more durable in character and largely the result of restrictive fiscal policy, relative stability of the dinar's exchange rate, anchored inflation expectations and low inflation abroad. In terms of groups of products and services, the only major positive contribution to core inflation in 2017 came from the prices of mobile telephony services (0.2 pp) and travel packages (0.1 pp).

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

III Macroeconomic environment

1 International environment

Continued growth in domestic demand and recovery in net external demand led to accelerated growth to 2.4% in the **euro area** in 2017, which is the highest growth rate on record since 2007. Positive developments in the labour market, favourable monetary conditions and increased consumer confidence continued to stimulate private consumption, which was the main driver of GDP growth. At the same time, investment growth was influenced by the corporate need for equipment upgrade, high capacity utilisation and better profitability of corporates. Faster global growth and the subsequently stronger external demand contributed to exports rising faster than imports, which resulted in a positive contribution of net exports to GDP growth.

Most of the leading euro area countries recorded faster GDP growth in 2017. Germany posted the highest growth rate in six years (2.2%), with a positive contribution of all components of domestic demand and net exports. Similarly, Italy's GDP growth was the highest in seven years and stood at 1.5%, while its acceleration relative to 2016 is the result of faster investment and export growth. The euro area GDP growth in 2018 is expected to remain dynamic and distributed across geographies, supported by the same factors as in 2017.

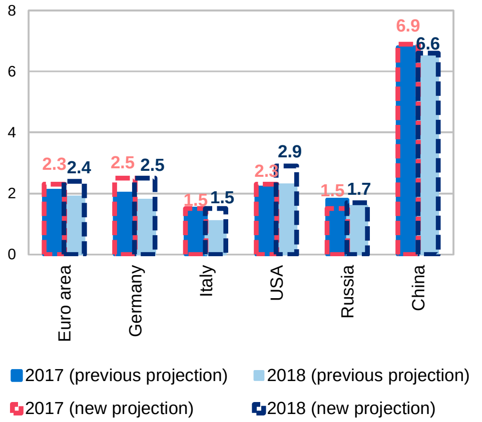
Despite the relatively robust economic growth, **inflation in the euro area** was below the target, "below but close to 2%." However, inflation in 2017 was still higher (1.5% y-o-y) than in 2016 (0.3% y-o-y) largely owing to the rising energy prices. Core inflation of 1.0% y-o-y in 2017 was only a tad higher than in 2016 (0.9% y-o-y) and still below its long-term average due to the prolonged moderate rise in wages and low pressures on the demand side. As for Serbia's main trade partners, Germany had somewhat higher inflation (1.7% y-o-y on average) than Italy (1.3%). Analysts estimate that inflation in the euro area was still relatively low in 2017 mostly due to the appreciation of the euro and the fact that, despite low unemployment (the lowest since 2009), wage growth remained moderate. They estimate that appreciation of the euro in 2017 "postponed" the expected inflation rise and that in 2018 inflation will remain below the target and will not strike the path of moderate growth until 2019. Considering the higher prices of oil and food products, in December 2017 the ECB revised up its inflation projection for 2018 – to 1.4%, from the September 2017 projection of 1.2%. The projection for 2019 was unchanged (1.5%), while an average inflation of 1.7% is expected in 2020. The ECB stated that inflation will rise gradually and come close to the target owing to monetary policy measures, continued economic growth, further absorption of economic slack and rising wages.

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

	Consensus Forecast January 2018		IMF April 2018	
	2017	2018	2017	2018
Poland	4.4	3.8	4.5	4.1
Czech Republic	4.4	3.3	4.3	3.5
Hungary	3.9	3.6	4.0	3.8
Albania	3.9	3.8	3.9	3.7
Bulgaria	3.8	3.6	3.6	3.8
Bosnia and Herzegovina	2.7	3.0	2.7	3.2
Macedonia	0.9	3.2	0.0	2.8
Romania	6.8	4.5	7.0	5.1
Slovenia	4.7	3.7	5.0	4.0
Croatia	3.0	2.8	2.8	2.8

Sources: Consensus Forecast and IMF.

Chart III.1.1 **Revisions of real GDP growth forecasts for 2017 and 2018 by the IMF**
(in %)



Sources: Sources: IMF WEO (October 2017) and IMF WEO (April 2018).

Continued robust growth in private consumption and recovery of investment contributed to the acceleration of **US** GDP to 2.3% in 2017. Favourable conditions in the labour market, indicated by the unemployment rate falling in December 2017 to its lowest level since early 2001 (4.1%), coupled with high consumer confidence, were conducive to continued growth in private consumption. In addition, good monetary conditions and higher profitability of companies affected the recovery of investments, which rose particularly in the energy sector due to the recovery in oil prices. Accelerated global growth and depreciation of the dollar encouraged a rise in exports, though the contribution of net exports was negative due to the faster rise in imports. Also, the tax reform adopted at the end of 2017 is supposed to exert a positive effect on investment growth and consumption, hence economic growth is expected to pick up in 2018.

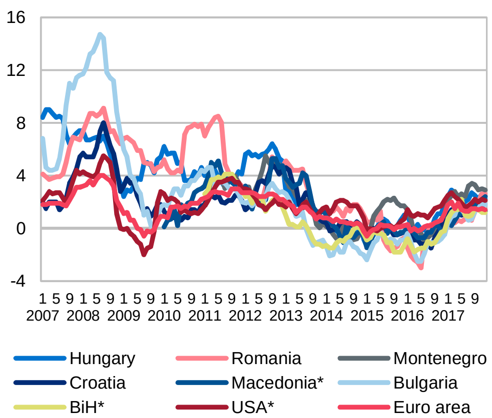
Inflation in the USA rose during 2017 and measured 2.1% y-o-y in December. At year level, the average y-o-y inflation rate also equalled 2.1%, which is higher than the average y-o-y inflation rate recorded in 2016 (1.3%). By contrast, core inflation in 2017 was 0.4 pp lower than in 2016 and equalled 1.8%. However, it is noteworthy that core inflation in December increased 0.3 pp from November, which is the highest rise in core inflation in the past 11 months. This encouraged expectations that higher inflation was sustainable and would hover around the Fed's target in 2018 owing to labour market recovery, hike in the prices of primary commodities, a weaker dollar and fiscal stimuli.

Favourable developments in the euro area were conducive to investment and exports in the **Central and Eastern European region**. In addition to favourable developments in the labour market and fiscal stimuli in some countries, this also led to an acceleration of economic growth in most of the countries in the region in 2017. The highest GDP growth was recorded in Romania (7.0%), while relatively high growth rates of more than 4.0% were recorded in other Central European countries as well (Poland, the Czech Republic and Hungary). Continued recovery in the labour market and investment growth were the main contributors to GDP growth in Western Balkan countries, while a positive contribution of the continued rise in exports was partly offset by the high increase in the import of equipment for investment purposes. Russia recorded economic recovery and 1.5% GDP growth owing to the recovery of oil prices, lower inflation and relaxation of monetary conditions.

Unlike in the prior period, in 2017 **inflation** moved in the positive territory **in all observed countries of Central and South-Eastern Europe**. The strongest impetus to the rise in consumer prices in this region came from global energy prices and the prices of food. According to analysts, inflationary pressures in these countries were still relatively low, though in 2017 some of them had the highest y-o-y inflation rates in the past several years. In most countries, core inflation remained relatively low due to the still relatively subdued pressures on the demand side. As for countries that had relatively high inflation in the prior period, Russia managed to lower its inflation to 2.5% y-o-y in December owing to its currency gaining strength and food prices going down in the wake of a good agricultural season. As the effects of these factors weaken, the Russian central bank expects inflation to rise gradually and return to the 4.0% target. Inflation in Turkey was still higher than in other countries in the region (11.9% y-o-y in December), with core inflation striking an upward path. The central bank believes that the overall effect of depreciation of the Turkish lira was the key inflation driver, though aggregate demand also yielded some contribution.

The Chinese economy continued to rebalance its growth structure in 2017, recording a faster rise in final consumption relative to investment, while the service sectors outstripped the industry. GDP growth was 6.9% and was mildly accelerated relative to 2016 (6.7%), largely due to increased external demand on account of faster global growth. The anticipated continuation of the tightening effect of monetary policy and economic

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.

rebalancing should reflect on the gradual slowdown in GDP growth in 2018.

Monetary policies of leading central banks, the ECB and the Fed, diverged further during 2017 as the euro area and the USA are going through different stages of their economic cycle. In 2017, the **ECB** kept its interest rates at historic minimums (key rate at zero and deposit facility rate below zero) and continued with net asset purchases of EUR 60 bn a month, announcing that they would be cut to EUR 30.0 bn from January until September 2018. It stressed that once the net asset purchases programme was completed, it would reinvest the principal payments from maturing securities over an extended period of time. Moreover, the ECB continued with main refinancing operations and three-month longer-term refinancing operations (LTROs) as fixed-rate tender procedures with full allotment for as long as it is necessary, and no sooner than the end of the latest required reserves maintenance period in 2019. According to the ECB, this will help maintain the favourable financing terms which are still needed for inflation to return to the target.

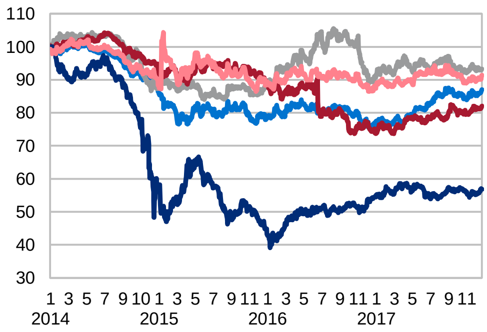
On the other hand, the **Fed** continued with monetary policy normalisation and, as expected, raised the federal funds target range three times in 2017, each time by 25 bp, to 1.25%–1.50%, primarily in view of rising economic activity and further strengthening of the labour market. Moreover, in June the Fed announced and in October it began with the normalisation of its balance sheet (which increased during the global economic crisis from USD 800 bn to USD 4.5 tn) by gradually decreasing its reinvestment of the principal payments it receives from securities purchased as part of the QE programme.[7] The shrinking of the Fed's balance sheet in Q4 was not considerable and most analysts see it as a signal to the market that the Fed is in no hurry to get back to normal. At the December meeting, the Fed voiced its expectations that the interest rate would most likely be increased three times during 2018 and twice in 2019.

The monetary policies of central banks in **Central and South-Eastern Europe** started to diverge in 2017 depending on economic conditions in each country. Thus, in April, the Czech central bank stopped resorting to interventions in the FX market (the aim of which was to prevent the strengthening of the local currency above the target level) and in August it increased the key policy rate by 20 bp to 0.25% in view of the anticipated rise in inflation amid growing wages and consumption. The key policy rate was once again raised in November, by 25 bp, and a further increase was discussed in December again, though it was eventually decided to wait given that the koruna gained more than had been expected. The central bank of Romania kept its key policy rate unchanged, but in October and November it narrowed the interest rate corridor by a total of 50 bp to ±1.0 pp. The central bank of Turkey continued to pursue tight monetary policy and it also kept its key policy rate on hold (8.0%), but it did increase interest rates on liquidity funds for banks in order to stabilise its currency and lower inflation.

In contrast to that, the central bank of Russia eased its monetary policy owing to a fall in inflation and inflation expectations, bringing the key policy rate down six times, from 10.00% to 7.75%, and announcing new cuts in 2018 as well. Although it kept its key policy rate on hold (0.9%), the Hungarian central bank announced that in order to boost lending and economic growth, it will continue with monetary policy accommodation through unconventional measures – namely, as of the beginning of 2018 it will start purchasing mortgage-backed securities with minimum three-year maturity and will hold auctions of five- and ten-year interest rate swaps in the total amount of around USD 1.2 bn. One of the few that still

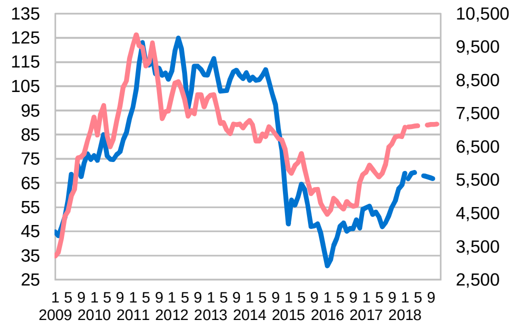
[7] According to the plan, the monthly reduction of reinvestment will be increased by USD 10 bn after each quarter until a monthly pace of USD 50 bn is reached around end-2018 (60% of this amount will be Treasury securities and 40% mortgage-backed securities). From then on, the Fed will apply a monthly cap of USD 50 bn for as long as it deems necessary.

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 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

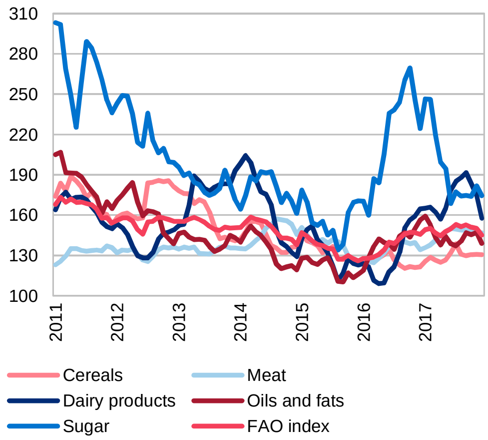
have not changed their monetary policy is the central bank of Poland, whose key policy rate has been at its minimum (1.5%) for more than three years.

Though the Fed's monetary policy was less accommodative, global financial conditions were favourable during 2017 as well, primarily owing to the ECB's loose monetary policy. Risk perception in the **international financial market** improved primarily on the back of better prospects of global economic growth. Yet, during the review period, market trends often changed directions under the sway of not only measures that were undertaken, but even more of expectations regarding the monetary policies of leading central banks, the Fed and the ECB, uncertainties surrounding the reforms of the new US administration, elections in some of the euro area countries and geopolitical tension. The complex effect of these factors was mirrored in the volatile trajectory of **yields on government securities of leading economies and currency relationships**. Thus the spread between US and German government securities at the start of the year was almost constantly above 200 bp, which is the widest spread since the introduction of the euro. Around mid-year, the spread was narrowed due to the rise in the yield on German securities and a fall in the yield on US government securities. As optimism regarding economic growth rose, so did the yields on US Treasuries, including the two-year government securities which overshot 2.0% in November for the first time since the crisis broke out. The yields on benchmark ten-year US Treasuries also rose, as well as the spread between US and German government securities, only to stabilise at around 200 bp at the end of the year. With fluctuations in the range of 1.04–1.21 dollars for one euro, **during 2017 the euro gained 12.1% against the dollar** after three years of weakening. This was made possible owing to better prospects for growth in the euro area, despite the ECB's accommodative policy and the Fed's monetary policy normalisation.

The global price of Brent oil was lowered in H1, though it edged up again in H2, averaging USD 54.4 per barrel in 2017, which is 23.5% higher than the average price in 2016. The price of oil peaked in December and it stood at USD 64.2 per barrel on average, up by 18.8% from the average price in January. The rise in the price of oil in 2017 was affected by both the supply- and demand-side factors. Of the former, the critical factor was the agreement of OPEC countries on capping production. The agreement was joined by Russia and another ten non-member countries, and in mid-year by Nigeria as well, which gave credence to market expectations of sustainability of the agreement. Other factors affecting the price of oil were fluctuations in US oil production. Analysts estimated that after grappling with huge financial difficulties in 2015, US oil producers were now ready to "endure" lower prices. Disruptions in oil production and distribution caused by the hurricane that hit the Gulf of Mexico and Florida, as well as the geopolitical tension in the Near East, also had an impact on global oil prices. On the demand side, better prospects for faster global growth paved the way for the oil price hike.

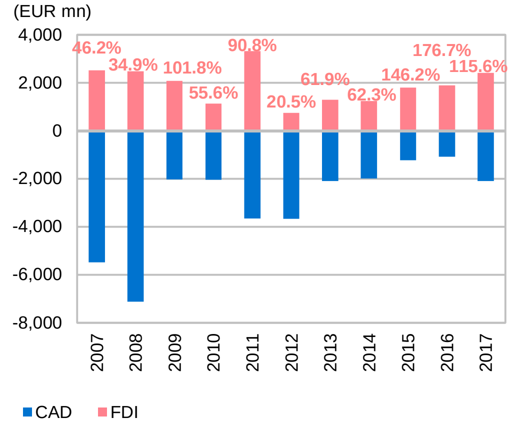
Besides oil prices, the **prices of base metals** also rose in 2017. Based on the IMF's index, which includes eight base metals, the prices rose by 14.4% during 2017. They

Chart III.1.5 **World food price index**
(in real terms, 2002–2004 = 100)



Source: FAO, UN.

Chart III.2.1 **CAD/FDI coverage***
(in %)



Sources: SORS and NBS.
* Preliminary data.

rose until February, continuing up on the path which they struck in 2016, and reversed their trend from March until June. After a sharp rise in Q3, they stabilised in Q4 at their highest level in three years.

Although they rose during the first three quarters, **global food prices** were on the decline in Q4 and at end-2017 they were slightly below (by 0.3%) their 2016 level, as measured by the FAO index. On average, food prices in 2017 were up by 8.2% from 2016 and at their highest since 2014. The prices of dairy products increased the most and, on average, they were 31.5% higher than in 2016. Meat was next with an average hike of 9.0% relative to 2016, and its price was still 4.7% below the five-year average (2012–2016). The average price of cereals, Serbia's important export product, recorded a rise of 3.2%. However, the prices of cereals were still 37% below the maximum from 2011. The average price of vegetable oil saw a similar increase (3.1%) and only the average price of sugar was lower by 11.2% than in 2016.

2 International transactions

Balance of payments and FX reserves

According to the preliminary data, **current account deficit** came at EUR 2,089.6 mn in 2017. The widening of the current account deficit relative to 2016 is mostly the consequence of a greater commodity deficit, caused by the rising imports of equipment in the environment of a strong FDI inflow, higher energy imports on account of growing industry needs, the oil price hike and unfavourable weather conditions at the beginning of the year, as well as lower exports of agricultural commodities in Q4 due to a bad agricultural season. This conclusion is also unequivocally indicated by the pace of the current account deficit throughout the year, i.e. its narrowing from 8.7% of GDP in Q1 to around 4% of GDP in the next two quarters, and then the pick-up to 6.6% in Q4. In 2017 the trade, and by extension also the current account deficit, were adversely affected by the terms of trade due to import prices rising faster than export prices, primarily on account of the oil price hike in the global market.

In 2017, **commodity exports** continued up at two-digit rates (10.0%), rising by EUR 1,275.4 mn compared to 2016. They are characterised by acceleration of manufacturing exports growth – from 11.6% in 2016 to 13.6% in 2017. Earlier investment, improvement of the business environment and enhancement of the domestic industry competitiveness are the supply-side factors which contributed to exports growth, and the demand-side factor was the acceleration of growth of the main foreign trade partners (the euro area and CEFTA countries). In addition to having faster growth, manufacturing exports also kept their wide sectoral dispersion, considering that in 2017 all areas recorded growth, with the exception of tobacco products, whose exports diminished from the maximum level in 2016. The largest contribution to commodity exports growth came from exports of base metals, rubber and plastic products, chemical products, electrical equipment, and other machinery and equipment, as well as metal products.

The year 2017 also saw a rise in **commodity imports** by EUR 2,142.7 mn or 13.4% from 2016, but with a favourable composition. The increase in imports of equipment, which was entirely expected at this stage of the investment cycle, accelerated from 2016 to 9.4% indicating greater investment. Imports of intermediate goods were higher, too (16.2%), which was also expected. This is a result of elevated imports of industrial raw materials, which is in line with the greater production and exports in manufacturing and increased energy imports. Around 60% of growth in the value of energy imports was the result of a hike in energy prices in the global market, while around 40% reflected higher import quantities on account of increased needs of economy. One part of this growth is generated by higher imports of consumer goods (3.4%), which is consistent with the gradual recovery of final consumption.

A positive balance in the **services account** increased further in 2017 (4.8%) to EUR 950.9 mn, owing to continued robust growth in services exports (14.6%). The greatest contribution came from the exports of computer and business services, which have been recording positive net exports since 2011, while transportation services gave a slightly less positive contribution.

In 2017 the **deficit in the primary income account** widened by EUR 547.8 mn. This occurred primarily due to expectedly higher FDI expenditures in the environment of a rising FDI inflow as a reflection of an improved business ambience and greater investors' confidence concerning the future economic developments. A large portion of earnings was reinvested in Serbia. Other expenditure groups in the primary income account were lower, primarily due to lower securities interest expenses and the decreased need of the government for borrowing in the environment of favourable fiscal developments. The **secondary income account** posted a EUR 356.5 mn increase in surplus in 2017 mostly as a result of a higher net inflow of remittances (9.9%).

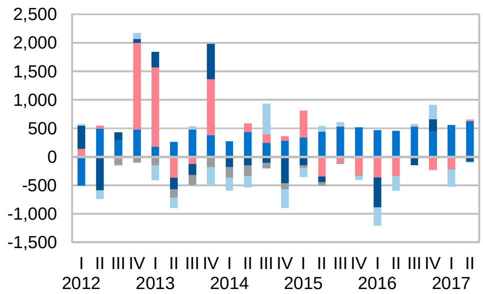
The **financial account of balance of payments** recorded favourable tendencies. Owing to improvement of the business environment, the net **FDI** inflow in 2017 kept rising, surpassing our expectations which were revised upwards several times during the year. **FDI** inflow was boosted by the creation of a more conducive business environment, the fall in the risk premium to its lowest level and improvement in the country's credit rating, progress on the Doing Business list and outlook for the coming period. The total gross FDI inflow in 2017 reached EUR 2.6 bn (6.9% of GDP), up by 19.6% relative to 2016. The total net FDI inflow reached EUR 2.4 bn (6.6% of GDP) in 2017, rising by 27.1% from 2016. The FDI inflow kept its sectoral dispersion and

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

	2016	2017
I CURRENT ACCOUNT	-1,074.9	-2,089.6
1. Goods	-3,118.9	-3,986.1
1.1. Credit	12,814.2	14,089.6
1.2. Debit	-15,933.0	-18,075.7
2. Services	907.0	950.9
2.1. Credit	4,570.8	5,240.2
2.2. Debit	-3,663.8	-4,289.4
3.Goods and services	-2,211.9	-3,035.2
3.1. Credit	17,384.9	19,329.8
3.2. Debit	-19,596.8	-22,365.1
4. Primary income	-2,022.2	-2,569.9
4.1. Credit	630.5	567.6
4.2. Debit	-2,652.6	-3,137.5
of which: interest	-1,047.0	-952.4
5. Secondary income	3,159.2	3,515.6
5.1. Credit	3,635.0	4,098.4
5.2.Debit	-475.9	-582.8
II CAPITAL ACCOUNT	-9.9	4.8
III FINANCIAL ACCOUNT (excluding reserve assets)	233.4	1,917.8
1. Direct investment, net	1,899.2	2,414.7
1.1. Net acquisition of financial assets	-227.8	-130.0
1.2. Net incurrence of liabilities	2,126.9	2,544.7
2. Portfolio investment, net	-916.8	-827.1
2.1. Net acquisition of financial assets	-121.2	53.2
2.2. Net incurrence of liabilities	-795.7	-880.3
3. Financial derivates, net	-9.1	20.6
3.1. Net acquisition of financial assets	-6.1	20.6
3.2. Net incurrence of liabilities	-3.0	0.0
4. Other investment, net	-739.9	309.7
4.1. Trade credit and advances, net	-209.4	-517.9
4.1.1. Net acquisition of financial assets	-923.5	-840.4
4.1.2. Net incurrence of liabilities	714.1	322.4
4.2. Financial loans, net	-303.5	203.3
4.2.1. Net acquisition of financial assets	-14.2	-130.7
4.2.1.1. Long-term	-13.2	-127.3
4.2.1.2. Short-term	-1.0	-3.4
4.2.2. Net incurrence of liabilities	-289.2	333.9
4.2.2.1. Long-term	-678.8	179.5
4.2.2.2. Short-term	389.6	154.5
4.3.Currency and deposits, net	-219.8	623.1
4.3.1. Net acquisition of financial assets	-173.8	445.7
4.3.2. Net incurrence of liabilities	-46.0	177.4
4.4. Other − net	-7.1	1.2
IV Reserve assets	301.8	-228.2
V NET ERRORS AND OMISSIONS	549.4	395.2
VI OVERALL BALANCE	-301.8	228.2

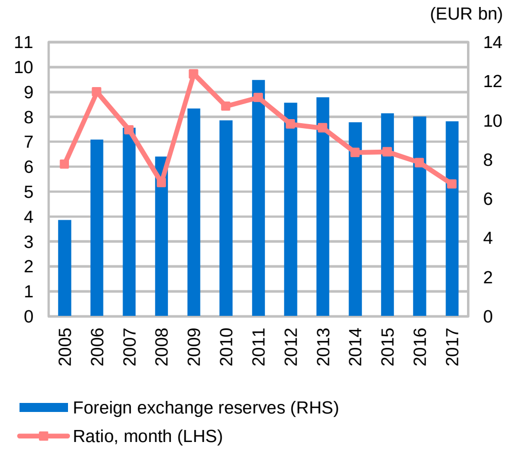
Sources: SORS and NBS.
Note: Preliminary data for 2017.
[1)] BPM6 methodology, except sign convention.

Chart III.2.2 **Structure of the financial account***
(EUR mn)



Sources: NBS.
* Preliminary data.

Chart III.2.3 **Ratio of FX reserves to imports**



Sources: SORS and NBS.

was mostly directed at manufacturing, the financial sector, construction and trade. Observed by country, it can be seen that the largest portion of FDI came from EU countries, like in previous years, but the inflow coming from China, Russia and the United Arab Emirates also rose compared to 2016.

Portfolio investment account recorded an outflow of EUR 827.1 mn in 2017, primarily due to EUR 570 mn-worth of eurobond payments to non-residents[8]. Despite eurobond maturing, the recorded outflow was by 9.8% lower than in 2016. Portfolio investment in the period January–April 2017 was characterised by the outflow of around EUR 300 mn, primarily caused by the Fed's continued monetary policy normalisation and a reduced investor exposure to emerging economies. Owing to a more favourable global growth outlook, investors' interest in the CEE region has been on the rise since May. In addition to expanding their investment in longer-maturity dinar securities in the primary market, non-residents first significantly diminished the sale of securities in the secondary market in Q2, and then became net buyers of securities in the secondary market in Q3. Therefore, in the period May-October, Serbia had a net inflow of portfolio investment in the amount of EUR 290 mn, almost entirely neutralising the net outflow at the beginning of the year. In the last quarter of 2017, portfolio investment was mostly affected by the eurobond falling due in November.

Other investment accounted for a net inflow of EUR 309.7 mn, as opposed to the outflow in 2016. Residents took **financial loans** abroad in the net amount of EUR 203.3 mn. Of that amount banks net borrowed EUR 272 mn, while other sectors reduced their foreign liabilities. Bank net borrowing on the grounds of financial loans in 2017 was recorded for the first time since 2010 and the beginning of the process of deleveraging. Owing to favourable developments in the financial account, i.e. inflows which outperformed the current account deficit, **NBS FX reserves** were up by EUR 228.2 mn in 2017, according to the balance of payments[9] methodology.

Although the net effect of FX transactions was positive (FX inflow exceeded FX outflow), FX reserves decreased by EUR 242.9 mn in 2017, due to negative net market effects (inter-currency changes, changes in the value of gold and market value of securities) amounting to EUR 471.1 mn. At end-2017, they amounted to EUR 9,961.7 mn, providing for 176.2% coverage of money supply M1, 234.1% coverage of external debt maturing within one year and more than five months' worth of goods and services imports. Amounting to EUR 8,274.0 mn, net FX reserves were by EUR 90.0 mn lower than at end-2016.

[8] In November, the principal for eurobond issued in 2012 was paid out, in the nominal amount of USD 750 mn.

[9] Excluding currency changes, changes in market value of securities and price of gold.

In the course of 2017, consistent with the fundamental principles of safety and liquidity, the funds were also invested in highly liquid securities issued by the most advanced economies and international financial institutions, and placed with prime institutions (central banks, international financial institutions and top-tier foreign banks). At end-2017 foreign securities accounted for the largest share of FX reserves (61.6%), followed by foreign currency held in accounts abroad (20.0%), foreign cash (10.9%), gold (6.8%) and SDR with the IMF (0.7%).

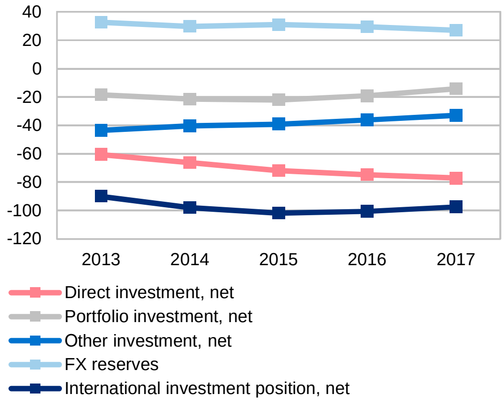
The FX inflow from the sale of euro-denominated RS securities in the domestic financial market equalled EUR 1,117.2 mn in 2017. Additionally, interventions in the IFEM[10] generated FX inflow in net amount of EUR 830.0 mn. Disbursements of RS credits brought in an inflow of EUR 733.5 mn, and temporary payment operations with Kosovo and Metohija[11] EUR 486.6 mn. FX inflow from donations amounted to EUR 232.8 mn and from investment in foreign securities and interest on FX assets – EUR 27.1 mn.

In 2017, liabilities to foreign creditors were settled in time (EUR 1,450.7 mn) in respect of both principal and interest. On account of euro-denominated RS securities falling due in the domestic financial market, EUR 1,002.9 mn was paid out from FX reserves, and on account of eurobonds (issued in November 2012 in the international financial market) – EUR 655.9 mn. In the period observed, banks withdrew EUR 284.8 mn worth of required reserve in the net amount, while EUR 23.1 mn was paid out to service old foreign currency savings bonds.

International investment position

Serbia's international investment position of a net debtor increased in 2017 by EUR 967.6 mn, to EUR 35,839.9 mn at year-end. However, it is important to note that **its structure improved and its share in GDP decreased**. Namely, an increase in the international investment position in 2017 resulted from strong growth of the most desirable form of investment from abroad – FDI. Accounting for more than half of total liabilities, FDI strongly grew in 2017 and continued to increase its share in total external liabilities, by 3.4 pp to 55.2%. In addition, in 2017 the share of the international investment position in GDP **decreased to 97.4% of GDP, the lowest level since 2013**. This share dropped by 3.3 pp from 2016.

Chart III.2.4 **International investment position***
(% of GDP)



Source: NBS.
* Preliminary data.

External financial assets of Serbia rose by EUR 286.3 mn to EUR 21,088.6 mn in 2017, with inter-currency and other changes accounting for a EUR 523.5 mn decrease. In the composition of financial assets, **other resident investment** abroad increased the most (EUR 477.1 mn), primarily as a result of a rise in trade loans and advances to non-residents (EUR 840.4 mn) owing to exports growth, while, contrary to 2016, cash and deposits of residents abroad went down (EUR 500.9 mn). Thereby, the share of other investment in total assets continued to increase, by 1.8 pp to 37.3%. The greatest share in total assets is still that of **FX reserves** (47.2%), which at end-2017 stood at EUR 9,961.7 mn. Outgoing **FDI** of residents remained on an upward path in 2017 as well, rising by EUR 130.0 mn. Receivables on those grounds reached EUR 3,013.9 mn, accounting for 14.3% of total assets. Resident **portfolio investment** abroad, which had been rising in previous years, decreased by EUR 68.3 mn to EUR 237.2 mn in 2017, so that foreign securities owned by Serbian investors still make up a small share of total assets (1.1%).

External financial liabilities of Serbia increased by EUR 1,253.8 mn to EUR 56,928.5 mn in 2017. The

[10] 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.

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

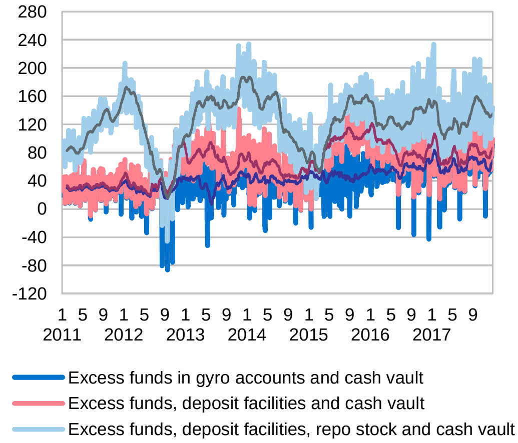
increase in foreign liabilities of residents resulted from the execution of transactions worth EUR 2,499.4 mn, while currency and other changes worked in the opposite direction, accounting for a EUR 1,245.5 mn decrease in liabilities. The year 2017 saw a continuation of a positive trend from past years, with financial liabilities rising primarily on the back of **FDI**, which expanded by EUR 2,598.3 mn to EUR 31,423.6 mn. In 2017 resident liabilities under **portfolio investment** decreased by EUR 1,433.5 mn, coming at EUR 5,503.4 mn or 9.7% of total liabilities at year-end. Almost the whole amount of the decrease in liabilities under portfolio investment concerns government liabilities to non-residents arising from debt securities, mostly the payout of the eurobond falling due. Part of the decrease stemmed from currency and other changes in the international financial market (EUR 553.2 mn). In the composition of financial liabilities, **other investment** amounted to EUR 20,000.4 mn at end-2017, almost unchanged from end-2016, as its increase due to transactions performed was offset by currency and other changes. Other investment continued to account for over 35% of total liabilities and mainly concerned resident liabilities under foreign financial loans. At end-2017 these loans stood at EUR 16,142.2 mn, down by EUR 319.2 mn from 2016, due to inter-currency and other changes amounting to EUR 653.2 mn. The greatest decrease on those grounds was recorded for government liabilities, by EUR 482.9 mn to EUR 9,669.4 mn. Also, liabilities of enterprises contracted (by EUR 157.5 mn to EUR 4,113.4 mn), while bank liabilities under financial loans increased (by EUR 333.8 mn to EUR 2,331.8 mn). Relative to end-2016, enterprises increased their foreign liabilities in the form of trade loans and advances by EUR 311.7 mn to EUR 2,279.2 mn at end-2017. In the composition of other investment, bank liabilities under cash and deposits of non-residents rose by EUR 177.4 mn to EUR 1,010.1 mn.

3 Financial market

Interest rates

In 2017, the average repo rate[12] continued to move close to the lower bound of the NBS's interest rate corridor. Having been broadly unchanged for eight months, it dropped to 2.6%, mirroring key policy rate cuts in September and October, and stayed at that level until year-end. The average repo rate in December 2017 was lower by 0.3 pp compared to end-2016.

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



Source: NBS.

Interest rates in the interbank money market showed similar movements – stayed almost unchanged until September and underwent a mild downward adjustment with the monetary policy easing. BEONIA averaged 2.4% in December, down by 0.4 pp from its average one year before. Activity in the interbank overnight money market was somewhat subdued – average trading volumes contracted by RSD 0.8 bn to RSD 2.9 bn in 2017. Average BELIBOR rates in December ranged from 2.5% for the shortest to 3.2% for the six-month maturity and were lower from 0.4 pp to 0.5 pp relative to end-2016.

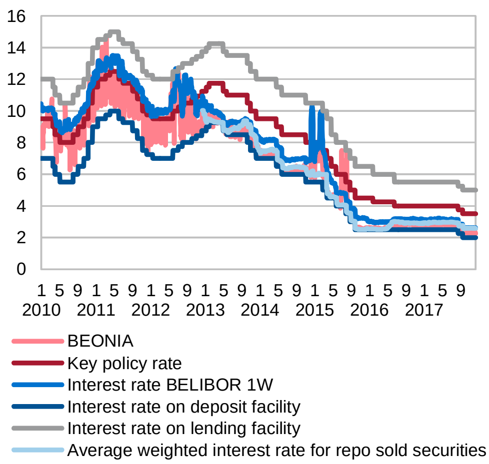
Improved fiscal position[13] and monetary policy accommodation pushed interest rates in the **primary market of dinar government securities** further down in 2017, primarily in the course of H2. The decrease was more pronounced for longer-maturity securities, so the rates on seven-year securities fell by 0.6 pp to 5.0%, on three-year securities by 0.5 pp to 4.3%, while the rate on two-year securities in October (4.05%) was by 0.25 pp lower than what was achieved at the last auction of this maturity in 2016.[14] Auctions of six-month and one-year securities were held only in Q1. Due to decreased borrowing needs, the government offered a lower amount

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

[13] Consolidated general government budget surplus of 1.2% of GDP was recorded in 2017.

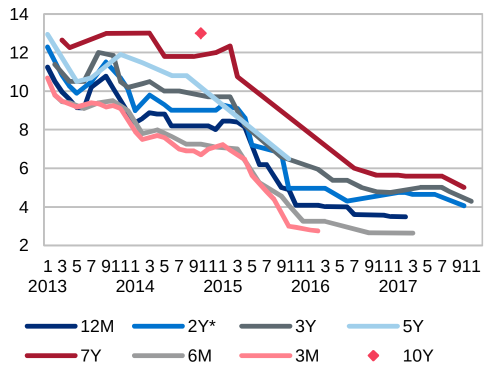
[14] This auction was held in June that year.

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.

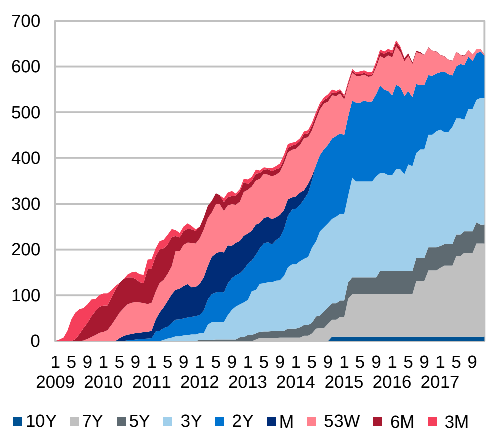
of securities for sale in 2017, and the demand outstripped the supply at majority of auctions. Higher demand, especially at actions of longest maturities, was driven by non-residents, who bought over 80% of the May issue and almost 70% of the October issue of seven-year securities.

Interest rates at auctions of government euro-denominated securities also declined. Late in the year, rates in this market segment moved from 0.5% on one-year securities to 4.2% on fifteen-year securities, which is a decrease of 0.1 pp to 0.5 pp compared to where they stood in 2016.

Total trading volume in the **secondary market of government securities** reached RSD 406.5 bn in 2017, down by RSD 1.0 bn from 2016. Observed by month, the greatest trading volumes were recorded in the beginning and towards the end of the year, owing to increased activity of non-residents. Yield rates mostly dropped, ranging from 3.2% for the remaining two-month maturity to 5.4% for the remaining 82-month maturity in December.

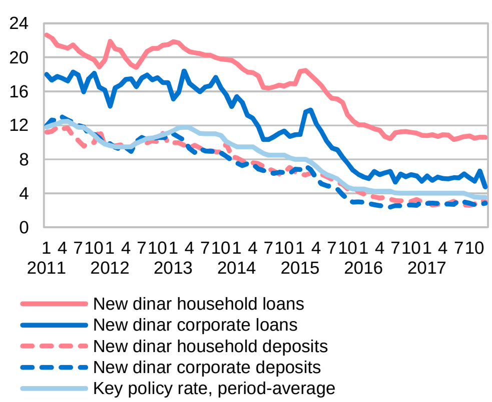
The cost of borrowing of the private sector went further down in 2017 – the **weighted average rate on dinar corporate and household loans** equalled 8.2% in

Chart III.3.3 **Stock of sold dinar government securities**
(RSD bn)



Source: Ministry of Finance.

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.

December, down by 0.3 pp relative to end-2016. Interest rates on all types of dinar corporate loans reached new lows in December. Compared to end-2016, rates on current assets loans fell by 0.6 pp to 4.3%, on investment loans by 0.3 pp to 5.5%, and on loans for other purposes by 1.0 pp to 5.0%. In December 2017, the weighted average rate on dinar corporate loans stood at 4.7%, down by 0.7 pp compared to end-2016.

The weighted average rate on dinar household loans also edged down, by 0.3 pp to 10.6% in December. Rates on other loans fell the most (by 1.1 pp) and they were approved at 9.0% in December. Rates on cash loans also declined (by 0.1 pp to 11.1%). Interest rate on consumer loans measured 8.3% at end-2017, which is an increase of 1.3 pp compared to the year before. **The weighted average rate on new euro-indexed corporate and household loans** dropped by 0.2 pp to 3.0% in December. The average rate on household loans edged down by the same amount, to 4.2% in December, as rates on housing loans fell by 0.1 pp to 3.0%, on consumer loans by 0.3 pp to 5.0%, and rates on cash loans and loans for other purposes by 0.5 pp each to 3.0% and 6.5%, respectively. The weighted average rate on euro-indexed loans to corporates declined by 0.3 pp to 2.8% in December. Rates on euro-indexed current assets loans and loans for other purposes each declined by 0.4 pp each, to 2.6% and 2.7%, respectively, while the price of import loans dropped by 0.3 pp to 2.1%, and of investment loans by 0.1 pp to 3.3%.

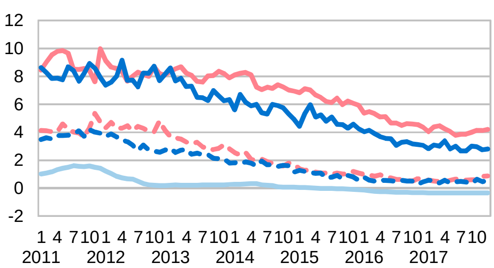
In December, banks' interest rates on household dinar savings were the same as one year before (3.0%), while rates on euro savings inched up 0.3 pp y-o-y (0.9%). **Interest rates on corporate euro deposits** increased (by 0.1 pp to 0.55%), while rates **on dinar deposits** decreased by the same amount, to 2.8% in Deceber.

Country risk premium

Measured by EMBI, Serbia's risk premium decreased by 147 bp during 2017, dropping to 102 bp. It fell below 100 bp in December, its lowest level on record for Serbia (April 2005). The decline in Serbia's risk premium in 2017 was more pronounced than that of emerging economies at the global and European level. EMBI Global lost 54 bp during 2017, arriving at 311 bp at end-December. EMBI Europe also went down by the same number of basis points, coming at 226 bp at end-December.

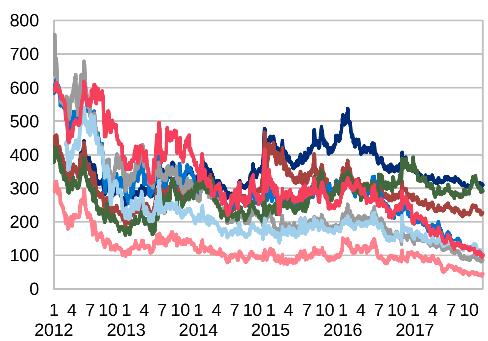
The fall in Serbia's risk premium was mostly affected by domestic factors, but also by regional and global factors. As for the former, the fall in Serbia's risk premium was predominantly caused by the preservation of macroeconomic stability and strengthening of macroeconomic fundamentals, and by the more favourable growth outlook for the coming period. Having achieved structural improvements and narrowed its internal and external imbalances, Serbia boosted its resilience to potential negative effects from the international environment. A confirmation of the results achieved and of further improvement of Serbia's macroeconomic outlook came from the IMF during its review under the precautionary arrangement, and also from all three rating agencies which improved Serbia's credit rating. Moody's

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.

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



Source: JP Morgan.

raised Serbia's credit rating in March and Standard & Poor's and Fitch in December 2017.

The fall in Serbia's risk premium was under the impact of global factors as well. Risk perception in the international financial market improved on the back of better prospects of global economic growth. Particularly important for countries in the region is the fact that during the year there was growing confidence that euro area economic growth would accelerate on a sustainable basis. Euro area growth was also supported by the ECB which pointed out that its monetary policy measures would remain stimulative for as long as necessary.

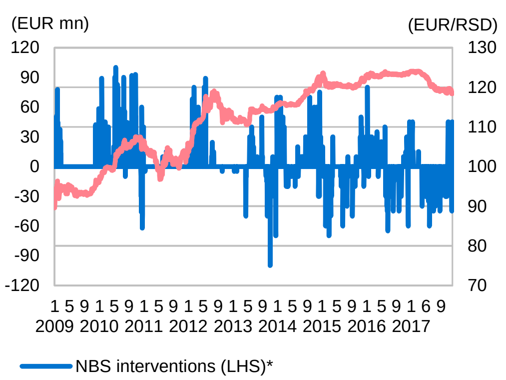
Besides domestic and global factors, regional factors also had an impact on the fall in Serbia's risk premium. Among them, the most important was certainly the improved outlook for growth of countries in the region, thanks to faster than expected economic growth in the euro area and better outlook for the period ahead. Faster economic growth in the euro area should facilitate these countries' adjustment to the expected normalisation of monetary policies of advanced economies.

Trends in the FX market and exchange rate

In 2017, the dinar gained 4.2% against the euro while due to the simultaneous strengthening of the euro on the dollar, it gained 18.2% against the US currency. Appreciation pressures in the FX market, which characterised most of the year, stemmed primarily from the narrowing in macroeconomic imbalances and more favourable macroeconomic prospects for the coming period, which also helped boost the confidence of foreign investors concerning long-term investment in Serbia, and contributed to the decline in the risk premium and the improvement in the country's credit rating by all three credit rating agencies – Moody's, Standard & Poor's and Fitch.

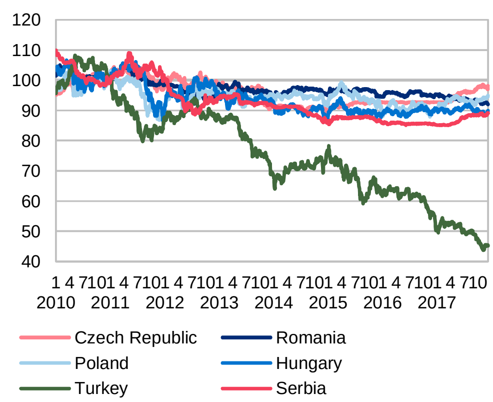
The beginning of 2017 was marked by depreciation pressures, which waned during February and March only to gradually turn into appreciation pressures as of April and until mid-Q4. Depreciation pressures on the dinar early in the year were under the impact of uncertainty in the international financial market, primarily due to the Fed's decision in December to continue with monetary policy normalisation, which induced foreign investors to reduce their portfolios of government securities. Of domestic factors, depreciation pressures in that period were largely fuelled by high FX demand of domestic enterprises, mainly energy importers. In the months that followed, FX demand of enterprises (measured by the amount of FX currency sold by banks to enterprises) decreased, prompted inter alia by better export results. In addition to dynamic exports, the strengthening of the dinar in 2017 was also influenced by a high FDI inflow

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.

which at the same time ensured the full coverage of the current account deficit. More favourable economic prospects and strengthening of macroeconomic stability helped boost foreign investors' appetite for government securities in the domestic market. After an extended period of time, they considerably increased their investments in government securities in May and became net buyers of these securities in the following six months.

Appreciation pressures were supported by a higher inflow of remittances, which was reflected on the purchase of foreign cash, as well as by the elevated FX supply generated by spending of foreign citizens, mostly tourists. The rise in banks' FX-indexed assets acted in the same direction.[15] These factors eased depreciation pressures which emerged around mid-November due to higher FX demand of domestic enterprises usual for the season, as well as in response to higher net FX sales to non-residents.

To ease excessive short-term volatility of the exchange rate, the NBS intervened in the IFEM by buying and selling foreign currency, closing the year as a net buyer of EUR 725.0 mn, and thereby additionally strengthening the FX reserves of the country.

The average daily trading volumes in the IFEM[16] rose to EUR 29.8 mn in 2017, up by EUR 5.6 mn from 2016. In line with higher trading volumes, the volatility of the exchange rate also increased slightly during 2017.[17]

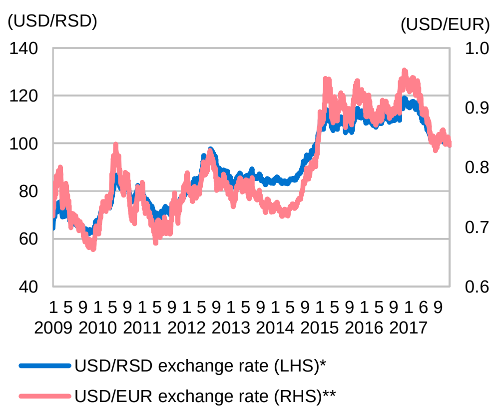
Of the currencies of countries in the region running similar exchange rate regimes, besides the dinar, the Polish zloty and the Czech koruna also strengthened, by 6.1% and 5.8% respectively, and the Czech central bank announced in April that it would no longer use the exchange rate as an additional instrument of monetary policy easing. The Hungarian forint also strengthened slightly (by 0.3%), while the Romanian leu weakened by 2.5% and the Turkish lira by 18.8%.

Stock exchange trends

At end-2017, both BSE indices rose by around 6.0% compared to end-2016. BSE indices oscillated in H1 in both directions and recovered in H2. At end-December, BELEX15 stood at 759.8 index points, its highest daily value since June 2011, while BELEXline went up to 1,662.5 index points, its highest daily value since October 2008.

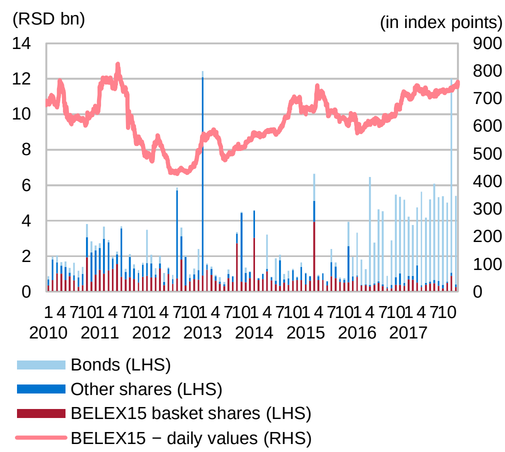
Though higher compared to 2016 (by RSD 1.8 bn), the values of trading in shares were still relatively low in 2017. Total shares turnover on the BSE in 2017 amounted to RSD 8.3 bn, of which RSD 5.6 bn related to the turnover of the most liquid shares. The highest turnover was recorded in March (RSD 1.5 bn), mostly as a result of trading in the MTP segment of the BSE.[18]

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.

[15] Aiming to balance their long open foreign currency positions, thus reducing exposure to exchange rate risk, banks sell foreign currency, which results in the strengthening of the dinar.

[16] Excluding the NBS.

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

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

In 2017, foreign investors participated with around 38% in the total shares turnover. As in the previous year, they were net sellers of shares, in the total amount of RSD 545.6 mn.

In 2017, total trading in bonds rose by RSD 20.5 bn to RSD 58.6 bn. Almost the whole turnover related to trading in long-term RS bonds, except in June, when EBRD bonds were also traded in the amount of RSD 60.0 mn.

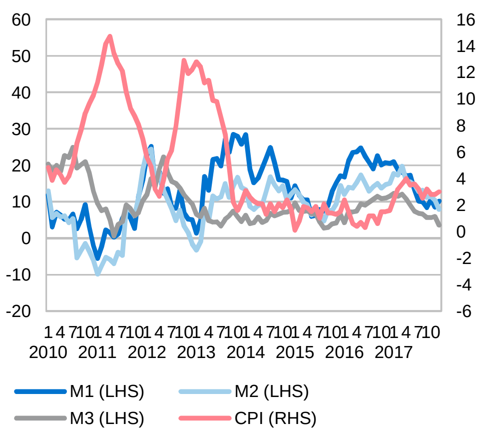
In 2017, BSE market capitalisation shrunk by RSD 43.6 bn to RSD 548.9 bn at end-December. Capitalisation of the regulated segment went down by RSD 14.4 bn, in part due to the exclusion and withdrawal of some issuers from the stock exchange. Capitalisation of the MTP market decreased by RSD 29.2 bn due to the exclusion of some issuers from this segment. This drove down the share of market capitalisation in estimated GDP by 1.6 pp to 12.3% at end-2017.

4 Money and loans

Monetary aggregates M1, M2 and M3

Money supply increased in 2017, with a more pronounced rise in its dinar component. The increase was facilitated by the further recovery of lending, while owing to improved fiscal position, the contribution of the government was significantly lower and even negative in the greater part of the year.

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



Sources: SORS and NBS.

Due to the fall at the start of the year usual for the season, all components of the dinar money supply declined in H1. Owing to the rise in H2, notably in Q4, the dinar money supply increased in 2017. The rise in dinar monetary aggregates was mostly driven by the increase in transaction deposits (RSD 57.2 bn) and, to a lesser degree, by the increase in cash in circulation (RSD 4.7 bn) and savings and term deposits (RSD 1.9 bn). Such developments resulted in M1 rising in real terms in 2017 by 7.0% and M2 by 4.7%. This and the further rise in FX deposits[19] pushed M3 up by 0.6% in real terms in 2017.

The increase in total transaction deposits in 2017 primarily resulted from higher balances in accounts of enterprises and current accounts of households, while non-profit organisations also contributed, though to a lesser extent. Consistent with expanding activity in the trade sector, deposits of trade companies recorded the

Table III.4.1 **Monetary survey**
(RSD bn)

	Dec. 2016	Dec. 2017	Changes in 2017
Net foreign assets	**1,156**	**986**	**-170**
Bank net foreign assets	-110	-201	-91
Net domestic assets of the banking sector	**1,041**	**1,289**	**248**
Net domestic loans	2,369	2,421	52
Net claims on government	340	353	13
Government loans	642	634	-8
Government deposits	-302	-281	21
Claims on non-government sectors	2,029	2,067	39
Loans to households	839	905	66
Loans to the corporate sector	1,127	1,103	-24
Loans to other financial corporations	29	31	1
Loans to local authorities	31	28	-4
Loans to non-profit and other organisations	2	1	-1
Other net assets	-1,328	-1,131	196
Money supply M3	**2,197**	**2,275**	**78**
Money supply M2	808	872	64
Money supply M1	608	670	62
Currency in circulation	159	164	5
Sight deposits	449	506	57
Dinar savings and term deposits	200	202	2
FX deposits	1,389	1,403	15

Source: NBS.

[19] The rise in FX deposits, expressed in dinars, was dampened by the dinar appreciation.

highest growth. More pronounced increase of deposits was also recorded by construction and manufacturing companies. Only the funds in the accounts of energy and agriculture companies declined.

Due to improved collection of fiscal revenues, the rise in dinar saving deposits of OFOs and local authorities played the key role in the increase of this category of deposits in 2017. Unlike transaction deposits, dinar savings and term deposits of corporates decreased, which is primarily linked to the decision of corporates and households to hold more liquid assets in a low interest rate environment. Household dinar savings equalled RSD 49.5 bn at the end of the year.

Household FX savings went up by EUR 395.3 mn in 2017 to almost EUR 9.1 bn by the end of the year. Owing mostly to this, as well as to higher amounts in corporate FX accounts (by EUR 186.2 mn), total FX deposits increased by EUR 598.5 mn and reached EUR 11.8 bn in 2017. FX deposits of other sectors also increased, though to a somewhat lesser extent.

Bank loans

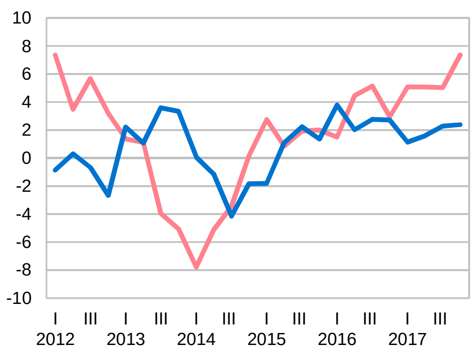
Excluding the exchange rate effect,[20] domestic loans increased by 7.3% in 2017, while their share in estimated GDP in December equalled 44.8%. Domestic household loans went up by 11.6% and corporate loans by 4.3%. Growth in private sector lending was achieved despite write-offs that exceeded last year's figures,[21] confirming that domestic lending activity is recovering at a faster pace.

To finance their lending activities, banks relied on domestic sources of funding, primarily household and corporate deposits,[22] and increase in capital, while potential for lending also increased on account of borrowing abroad.

According to preliminary data, excluding the exchange rate effect, corporate loans increased by 4.3% or RSD 42.4 bn in 2017. Growth was recorded with companies, while public enterprises borrowed less than a year earlier. Loans were mostly extended to trade, manufacturing and construction companies, i.e. sectors that contributed the most to GDP growth in 2017. By purpose, current assets loans still accounted for the bulk of bank receivables from corporates in December (48.8%), while investment loans made up 31.5% of these receivables.

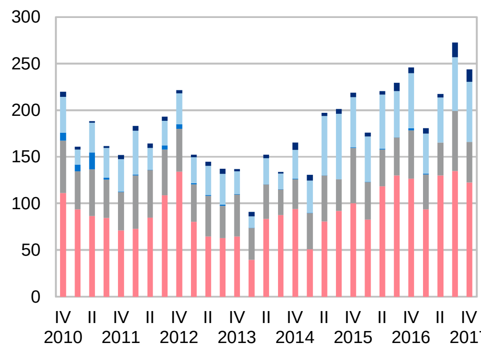
More favourable tendencies were also confirmed by the total amount of new corporate loans in 2017 (RSD 914.9 bn), which was up by 4.9% when compared to 2016. Companies still mostly used current assets loans, which made up around 56% of new corporate loans. Investment loans also maintained a relatively high share in new loans

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



Sources: NBS and SORS.
* Excluding the exchange rate effect.

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



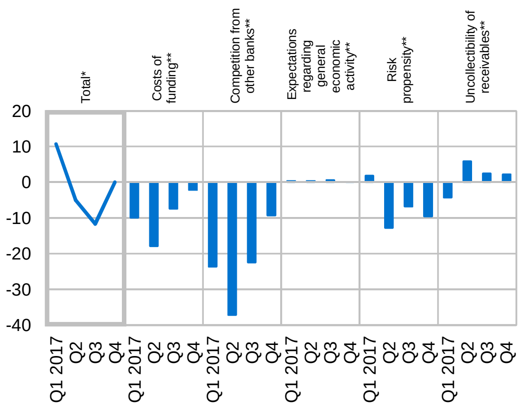
Source: NBS.

[20] Calculated at the dinar exchange rate against the euro, Swiss franc and US dollar as at 30 September 2014 (the so-called programme exchange rate used for monitoring the performance under the arrangement with the IMF), taking into account the currency structure of loan receivables.

[21] In 2017, banks wrote off RSD 74.3 bn of corporate NPLs and RSD 23.5 bn of household NPLs.

[22] Loans rose slightly faster than the deposit base, causing LTD (Loan-to-Deposit ratio) to increase by 0.3 pp to 7.1% in 2017.

Chart III.4.4 **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.

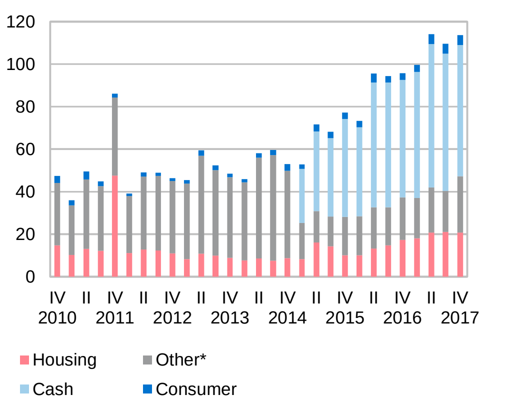
* Positive values indicate tightening and negative easing of credit standards relative to the previous quarter.

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

(22%), while thanks to higher amounts approved during H2, the share of import loans edged up to 7%.

The results of the NBS bank lending survey[23] indicate that credit standards for corporates were slightly tighter in Q1

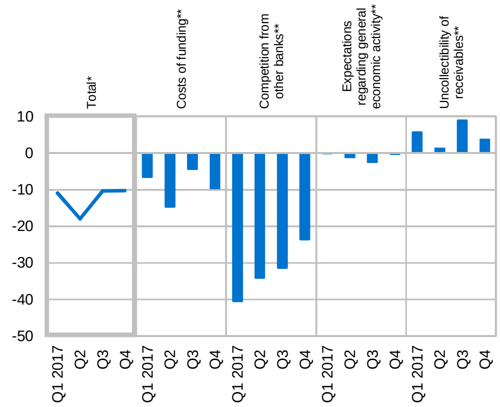
Chart III.4.5 **Structure of new household loans**
(RSD bn)



Source: NBS.

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

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.

and then eased in the remainder of the year,[24] mostly in relation to small and medium-sized enterprises. Throughout the year, standards were eased due to interbank competition and less expensive sources of funding, as well as due to higher risk propensity of banks as of Q2. Corporate borrowing terms were more favourable due to lower interest margins and associated costs, with the extension of maximum loan amount and maturity, which is probably why collateral requirements were slightly tightened. Corporate loan demand continued up, largely driven by the need to finance current assets and investment and, to a lesser degree, by debt restructuring.

Household lending continued to post robust growth in 2017 (RSD 93.2 bn excluding the exchange rate effect, or 11.6%). As before, such growth was largely driven by dinar cash loans (including refinancing loans) which increased by RSD 56.1 bn. Housing loans exerted a greater impact than earlier, having risen by RSD 17.3 bn in 2017, excluding the exchange rate effect. This is 2.3 times higher than in 2016 and the sharpest rise since 2011, when the subsidised housing loan scheme was in place.

The volume of new household loans in 2017 (RSD 436.9 bn) expanded by 22% compared to 2016. Cash loans accounted for around 58% of new loans to households,

[23] The NBS conducts the survey since early 2014 on a quarterly basis. Participation is voluntary and the response rate almost 100%.

[24] In aggregate terms, banks did not change corporate credit standards in Q4; however, according to the corporate criterion, standards were relaxed for SMEs, which is in line with the assessments expressed in the EIB's CESEE Bank Lending Survey.

72% of which had a repayment term of more than five years. The recovery in housing loans was also confirmed by the volume of new housing loans in 2017 (RSD 80.6 bn) which was 45.4% higher than in 2016. An increase was also recorded in the use of consumer loans, current account overdrafts rose slightly, while borrowing on credit cards was somewhat lower than in 2016.

Results of the lending survey indicate a further relaxation of credit standards for households in 2017, largely in terms of cash and housing loans. This was mainly prompted by interbank competition and lower costs of sources of funding, and, to a lesser extent, by increased risk propensity and favourable prospects in the real estate market. Borrowing terms for households were more favourable due to even lower interest margins and associated costs, extended maturities for dinar loans, while in the first three quarters collateral requirements were also relaxed. In line with expectations, household demand continued to rise, with the greatest demand registered for dinar cash loans and refinancing loans, and FX-indexed housing loans. The main factors that drove demand up were the refinancing of current obligations, rising employment and wages in the private sector, and purchase of real estate.

Thanks to NBS measures and the successful implementation of the NPL Resolution Strategy, which was further supported by the implementation of the Decision on the Accounting Write-off of Bank Balance Sheet Assets[25] as of September 2017, as well as owing to the rise in lending, the share of NPLs in total loans posted a sharp fall. During Q4, their share dropped below the pre-crisis level and equalled 9.8% in December. In 2017 alone, the share of NPLs contracted by 7.2 pp, while relative to July 2015, i.e. right before the Strategy was adopted, it was 12.5 pp lower. The NPL share in the corporate sector dropped by 6.8 pp to 10.4%[26] and in the household sector by 3.7 pp to 5.6%.[27] In terms of maintaining financial stability, it is important to underline that NPL coverage is high – total allowances for loan impairment came at 66.8% of NPLs in December, while loan loss reserves continued to fully cover gross NPLs and equalled 133.3% in December. Also, after the introduction of Basel III standards,[28] the capital adequacy ratio rose further, to 22.6% in December, indicating the high capitalisation of the domestic banking sector.

5 Dinarisation

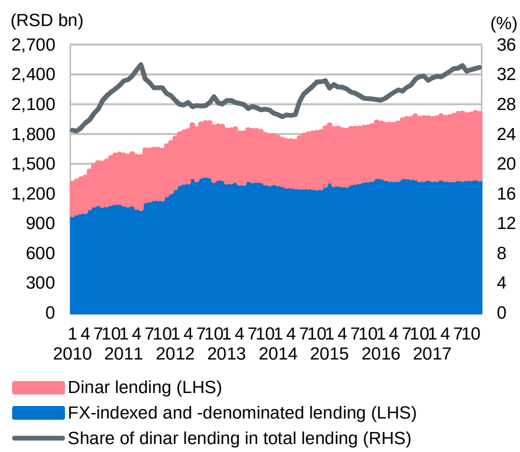
During 2017, the NBS continued to encourage the use of the dinar in the Serbian financial system. Monetary policy measures adopted by the NBS helped preserve price stability, relative stability of the exchange rate of the dinar and stability of the financial system in this period, which is the key precondition for building up confidence in the dinar.

Also, through its reserve requirement policy, the NBS continued to encourage banks to rely more on dinar sources of funding. Namely, the required reserve ratios on dinar sources of funding are still lower than those on FX sources, and the NBS offers remuneration on required reserves in dinars only, and not in foreign currency.

The NBS continued to work on the development of basic FX hedging instruments. During 2017, 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.

In 2017, the degree of dinarisation, **measured as the share of dinar loans in total corporate and household lending**, rose from 31.2% at end-2016 to 33.0% by the end of the year. This is the highest degree of dinarisation

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



Source: NBS.

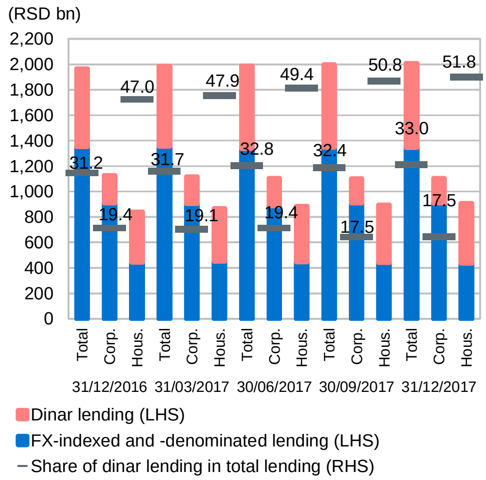
[25] According to this Decision, in effect as of 30 September 2017, banks are required to write off all loans whose allowances for impairment equal 100% of their gross book value.

[26] Includes companies and public enterprises. Looking at companies only, the share of NPLs in total loans stood at 10.8% in December 2017, down by 6.8 pp from the year before.

[27] With entrepreneurs and private households included, the share decreased by 4.1 pp to 5.9%.

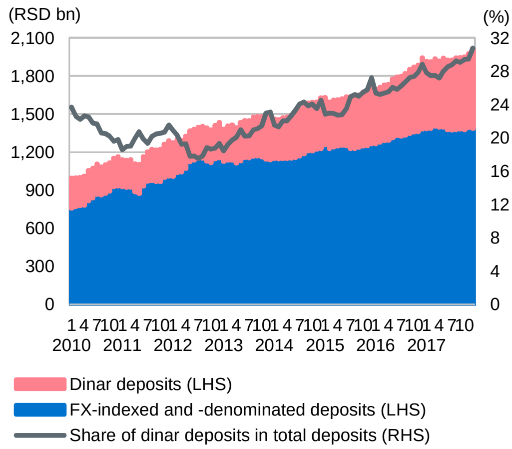
[28] The regulatory framework of Basel III standard came into force on 30 June 2017.

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.

of loans since June 2008, i.e. since this indicator is monitored. Sector-wise, the rise in dinar loans in 2017 is mainly attributable to increased household lending, primarily the rise in cash loans which were entirely dinar-denominated. FX and FX-indexed loans to households declined in nominal terms, triggered by the appreciation of the dinar. These movements were conducive to a further rise in the dinarisation of household lending from 47.0% at end-2016 to 51.8%.

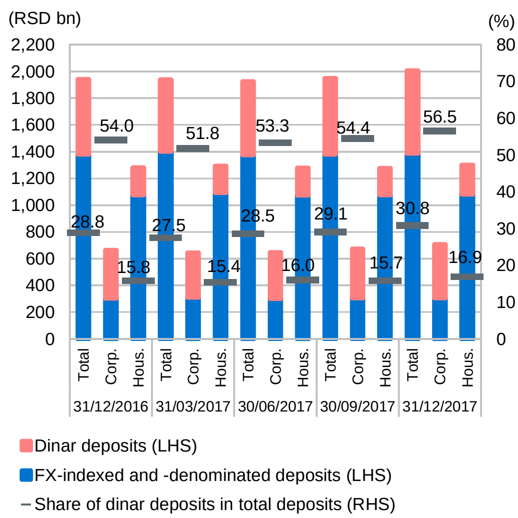
The degree of dinarisation of corporate lending decreased in the same period by 1.9 pp to 17.5% at end-2017. Such fall in the dinarisation of corporate lending is largely attributable to NPL resolution efforts, i.e. write-offs and sale of a portion of those receivables to non-banking sector entities. In September 2017 alone, i.e. when the NBS Decision on the Accounting Write-Off of Bank Balance Sheet Assets[29] came into effect, the degree of dinarisation of corporate loans dropped from 19.1% to 17.5% at end-2017.

Excluding the exchange rate effect,[30] the degree of loan dinarisation rose from 32.3% at end-2016 to 32.9% at end-2017.

Regarding the **degree of dinarisation of deposits**, the share of dinar deposits in total corporate and household deposits with banks came at a historic maximum of 30.8% at end-2017, up by 2.0 pp relative to end-2016.

Sector-wise, the share equalled 16.9% for households at end-2017, meaning its upward trend was maintained (by 1.1 pp in 2017) mainly owing to the rise in transaction deposits that can be associated with favourable developments in the labour market. Relative to end-2012, when the upward trend began after the NBS and the Serbian Government signed the *Memorandum on the*

Chart III.5.4 **Deposits by sector**



Source: NBS.

[29] According to this Decision, banks are required to write off all loans whose allowances for impairment equal 100% of their gross book value.

[30] Calculated at the dinar exchange rate against the euro, Swiss franc, US dollar, pound sterling and the Japanese yen as at 30 September 2014, taking into account the currency structure of loan receivables.

Strategy of Dinarisation of the Serbian Financial System in April that year, the share rose by 8.1 pp.

In the same period, the degree of dinarisation of corporate deposits increased (by 2.5 pp) to 56.5% in response to the dynamic growth of dinar transaction deposits. At the same time, the highest increase was recorded in the transaction deposits of companies in trade, construction and manufacturing, namely sectors with the biggest contribution to GDP growth in 2017.

6 Inflation expectations

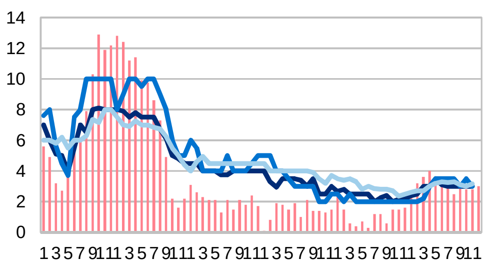
Owing to four years of low inflation, with low expected inflationary pressures, during 2017 the short- and medium-term inflation expectations of the financial sector and corporates were anchored within the bounds of the NBS target. For the major part of the year they hovered around the target midpoint.

The Bloomberg and Ninamedia survey results indicate that **one-year ahead inflation expectations of the financial sector** increased during H1, rising from extremely low levels in 2016. After that they moved closer to the target midpoint. Hence, according to the **Bloomberg** survey, inflation expectations edged up 0.8 pp to 3.3% in H1 and remained there until September when they slid to 3.1% for the remainder of the year. The results of the **Ninamedia**[31] survey show that the sector's inflation expectations rose by 1.0 pp during H1 and came at 3.1% in June. The following month they edged down to the target midpoint (3.0%) and remained there until the end of the year. The results of both surveys indicate that as of October 2013, one-year ahead inflation expectations of the financial sector have been within the NBS target tolerance band (3.0±1.5%).

According to the results of the survey of **one-year ahead inflation expectations of corporates**, after rising from 2.0% to 2.2% in March, expectations of corporates moved in the 3.0–3.5% range until the end of the year. Since August 2016, **inflation expectations of the household sector** were somewhat higher and more volatile until March 2017 when they returned to the level of 5.0% where they had stood for almost a year, until August 2016. Following a temporary rise in April, they again stabilised at 5.0% and remained there for the remainder of the year.

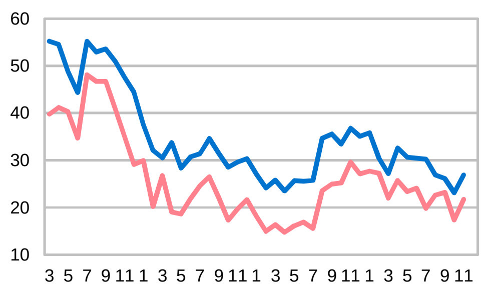
The results of the **qualitative survey of households**[32] show that during 2017 perceived inflation in the past 12 months was lower, as well as expected inflation in the upcoming 12 months. Regarding households, expected inflation is still lower than perceived inflation, meaning

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



Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.
* Ipsos and Gallup agencies until December 2014, Ninamedia agency since December 2014 until December 2017.

Chart III.6.2 **Inflation perceived and expected by households***
(in index points)

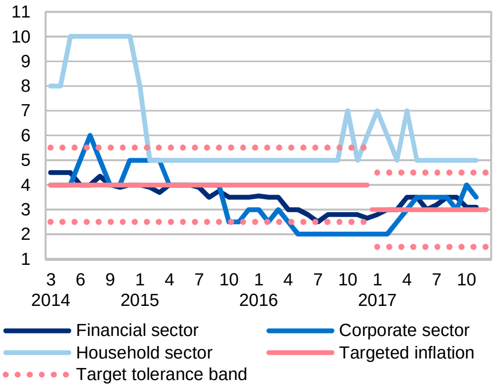


Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.
* Ipsos and Gallup agencies until December 2014, Ninamedia agency since December 2014 until December 2017.

[31] Ninamedia conducted the survey on expectations of economic agents from December 2014 to December 2017.

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

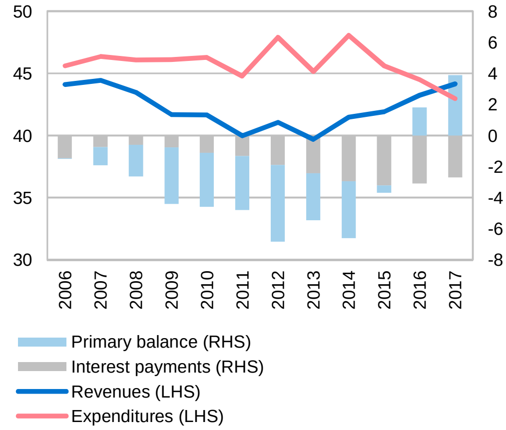
Chart III.6.3 **Two-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Ipsos/Ninamedia and NBS.

* Ipsos and Gallup agencies until December 2014, Ninamedia agency since December 2014 until December 2017.

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



Source: Ministry of Finance.

that one part of the population, who feel that prices increased in the past twelve months, do not expect the trend to continue in the coming period.

Medium-term inflation expectations of the financial sector and corporates continued to move within the target tolerance band in 2017. Expectations of the financial sector moved from 2.8% to 3.5% but by the end of the year they were lowered to 3.1%. Medium-term expectations of **corporates** rose 1.5 pp to 3.5% in 2017, while expectations of **households** dipped 1 pp to 5.0%.

7 Fiscal trends

In 2017, fiscal trends were significantly more favourable than expected – for the first time since 2005, there was a surplus at the consolidated level of RSD 52.3 bn or 1.2% of GDP. Excluding interest expenses, the surplus at the consolidated level came at 3.9% of GDP. Continued positive fiscal trends in 2017 were mostly driven by the rise in domestic demand and better performance of companies, labour market recovery and more efficient tax collection. In 2017, no additional fiscal consolidation measures on the income side were implemented, but owing to the rise in domestic demand and profitability of companies, further labour market recovery and rising efficiency with tax collection, the 2017 **consolidated revenues** were up by 4.0% in real terms compared to the year before. In 2017 they amounted to RSD 1,973.4 bn (44.2% of estimated GDP). Growth in government revenues from VAT, at 2.6% in real terms, was driven by improved collection of public revenues[33] and recovery of final consumption. Excise revenues grew by 2.3% in real terms, owing to the reduction of the grey market and increase in the consumption of individual excise products, and to a lesser extent also to the rise in specific excise amounts based on regular adjustments. Revenues from corporate income tax were higher by 35.0% in real terms, on account of better performance of companies in 2016. More favourable labour market trends brought about higher revenues from contributions, by 4.4% in real terms, which, observed on an individual basis, were the main driver of rising revenues. Personal income tax increased by 5.1% in real terms. Only non-tax revenues remained unaltered in nominal terms relative to 2016.

In 2017 **consolidated expenses** amounted to RSD 1,921.1 bn (43.0% of estimated GDP) and were down by 1.7% in real terms relative to the year before, with a significant contribution coming from the fall in interest expenses. Interest expenses dropped (10.6% in real terms) amid decreasing government need for borrowing and lower borrowing price, driven by the NBS monetary policy easing and the fall in the country risk premium. Repayment based on issued guarantees was also lower than in the year before and equalled 0.6% of GDP in 2017. Subsidies also worked in the same direction and fell

[33] Measured by the C-efficiency ratio, it equalled 76.7% in 2017, relative to 75.3% in 2016.

by 2.3% in real terms. Owing to the continued right-sizing of public sector employment, employee expenses were down by 0.9% in real terms and stood at 9.5% of GDP in 2017. At the same time, budget allocations for pensions accounted for 11.1% of GDP in 2017. Annual capital expenditures were down by 6.7% in real terms, but project implementation accelerated in H2. Higher outlays for the purchase of goods and services (of 3.3% in real terms) are partly due to methodological changes at the level of local governments.

Positive fiscal trends, along with the maturing of USD 750 mn worth of eurobonds issued in 2012 and the effects of cross-currency changes, led to a further **decline in central government public debt**, which stood at EUR 23.2 bn at end-2017, down by over EUR 1.6 bn from end-2016. In this way, the downward path of the share of public debt in GDP, initiated in 2016, continued in 2017 at an accelerated pace – the share of public debt in the projected GDP in 2017 was cut by 10.4 pp to 61.5%, of which 3.7 pp was on account of cross-currency changes and the rest on account of the positive effect of domestic factors, primarily the achieved primary surplus. At end-2017, 77% of public debt was in foreign currency, while the share of debt in USD was cut to 29%. Targeted mid-term fiscal deficit level of around 0.5%, anticipated by the 2018–2020 Fiscal Strategy, will keep public debt on the downward path in the coming period.

8 Aggregate demand

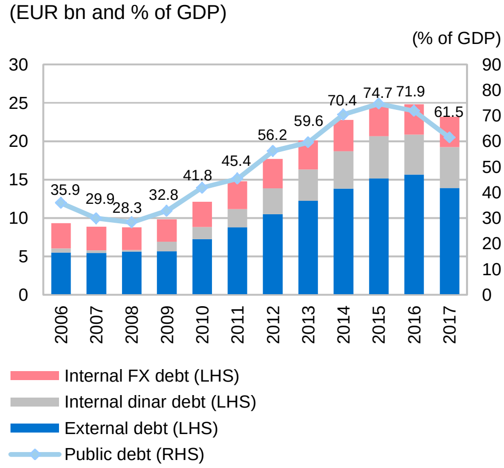
In 2017, the 1.9% GDP growth was driven by domestic demand. Preserved macroeconomic stability, continued improvement of business environment, implementation of infrastructure projects and low costs of financing contributed to rising investment, while favourable labour market trends were conducive to the continued recovery of household consumption. Exports also continued recording high and dispersed growth. However, the contribution of net exports to GDP developments was negative due to the faster increase in imports, primarily of equipment and intermediate goods for industrial purposes, which is associated with the investment cycle.

After a somewhat slower growth at the beginning of the year, brought about by the supply-side shocks, primarily the cold weather effect, in the remainder of the year GDP growth accelerated[34], mainly owing to a faster increase in private investment and recovery of government investment.

Domestic demand

Favourable labour market trends continued to have a positive effect on **household consumption**, which rose in 2017 by 1.8% in real terms and was a positive contribution to GDP (1.3 pp). This is indicated primarily by the wage

Chart III.7.2 **Public debt***
(EUR bn and % of GDP)



Source: Ministry of Finance.
* Central government.

Table III.8.1 **GDP distribution in 2017**

	Y-o-Y growth rates (%)	Contribution to GDP growth (pp)
GDP at constant, previous year prices	**1.9**	**1.9**
Domestic demand	3.3	3.8
Total final consumption	1.7	1.5
Private consumption	1.8	1.3
Government consumption	1.0	0.2
Investment	10.3	2.3
Fixed investment	6.2	1.2
Private investment	8.7	1.4
Government investment	-6.7	-0.2
Change in inventories	-	1.0
Net exports (exports − imports)	-14.2	-1.9

Sources: SORS and NBS calculation.

[34] In Q1 1.1%, in Q2 1.6%, in Q3 2.3%, and in Q4 2.4%.

Table III.8.2 **Key indicators and sources of household consumption in 2017**
(real y-o-y growth rates, in %)

Household consumption	**1.8**
Indicators	
Retail trade	3.7
Catering turnover*	7.7
Number of domestic tourists	7.9
Number of overnight stays of domestic tourists	7.4
Imports of consumer goods (BEC classification), nominal	3.6
Sources	
Private sector wage bill, nominal	9.2
Net remittances inflow, nominal	9.9
New consumer loans, nominal	30.8
New cash loans, nominal	17.8

Sources: SORS and NBS calculation.

Table III.8.3 **Investment indicators in 2017**
(y-o-y growth rates, in %)

Construction sector (national accounts)	5.5
Number of issued construction permits	45.8
Production of construction material	3.5
Value of works done (territory of Serbia)	5.2
Gross fixed capital formation (national accounts)	6.2
Imports of machinery and equipment	9.8
Production of capital goods	6.8
New investment loans	-1.5
FDI	27.1

Sources: SORS and NBS calculation.

bill increase in the private sector, which grew by 9.2% in nominal terms, driven by higher employment and higher average wage. In addition, other sources of household consumption also recorded an increase in 2017. Favourable financing conditions on account of previously undertaken monetary policy measures reflected on the rise in new consumer loans – consumer (30.8%) and cash loans (17.8%). The inflow of remittances increased as well (9.9%). Rising household consumption was also indicated by the evolution of the main indicators – turnover in retail trade and catering, number of domestic tourist arrivals and overnight stays, which were rising constantly throughout the year at the y-o-y level.

In 2017, the real increase in **final government consumption** amounted to 1.0%, with a positive contribution to GDP growth of 0.2 pp. Such development is a result of elevated expenditures for the purchase of goods and services (3.3%), while, expectedly, the continued public administration right-sizing contributed to a drop in public sector wage expenditures (0.9%).

A positive contribution to GDP also stemmed from **fixed investment** (1.2 pp), which rose throughout the year and recorded annual growth of 6.2% on account of continued improvement of the business environment and favourable monetary conditions. The rise in the total fixed investment was also driven by the government investment, which grew constantly from Q2, owing to the more intensified implementation of infrastructure projects. Higher investment is primarily suggested by indicators in the construction area, i.e. the rise in the value of executed works, production of construction material, employment in construction and the number of issued construction permits. Additionally, imports of equipment also rose, as well as domestic production of capital goods.

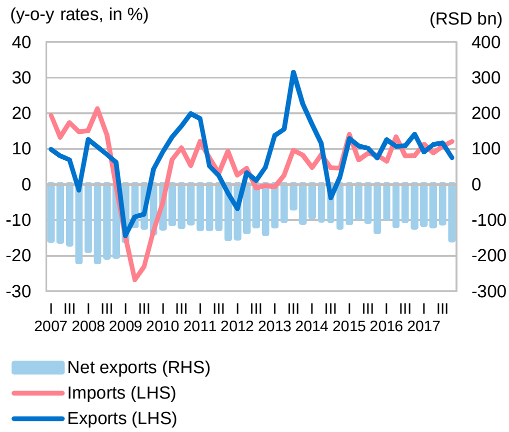
The sources of investment financing also continued to record increase. We estimate that companies' own funds accounted for the major portion of sources of investment financing, since the profitability of companies significantly improved in 2016 (RSD 229.3 bn) relative to 2015 (RSD 67.2 bn). In 2017 FDI inflow rose by 27.1% owing to constant improvements in the business environment, which also contributed to Serbia's further progress on international competitiveness lists. As in the past two years, new investment loans were a significant source of financing, amounting to RSD 213 bn in 2017.

In addition to fixed investment, a positive contribution to GDP also stemmed from increased **inventories** (1.0 pp), which is primarily indicated by the inventories of finished industrial products which were higher by 14.3% at end-2017, relative to 2016.

Net external demand

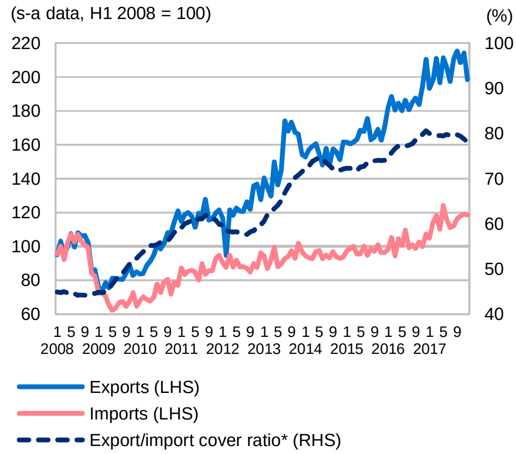
Owing to continued past investment performance and additional growth acceleration in the euro area and neighbouring countries, real **exports of goods and services** kept recording a relatively high rise (9.8%) in 2017, as well. On the other hand, higher investment brought about an increase in the imports of equipment, while intensified industrial activity and rising oil prices reflected on the higher imports of energy and intermediate goods, which is why growth of the **imports of goods and services** accelerated to 10.7%, hence the contribution of net exports to GDP was negative (1.9 pp).

Chart III.8.1 **Exports and imports of goods and services**
(in previous-year constant prices, ref. 2010)



Sources: SORS and NBS calculation.

Chart III.8.2 **Commodity trade in euros**



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

In 2017 the rise in commodity exports, expressed in euros, stood at 10.0% and was driven by the exports of manufacturing, which additionally accelerated to 13.6%, from 11.6% in 2016. Exports rose in 22 out of 23 manufacturing areas, indicating broad product dispersion. The greatest contribution to growth stemmed from the exports of base metals, rubber and plastic products, chemical products and machinery and equipment. On the other hand, poor agricultural season and cold weather at the beginning of the year were the reason for lower exports of agricultural products (7.4%). Apart from commodity exports, the exports of services also kept recording high growth (14.6%), largely owing to the rising exports of ICT and business services, and less to transport and tourist services.

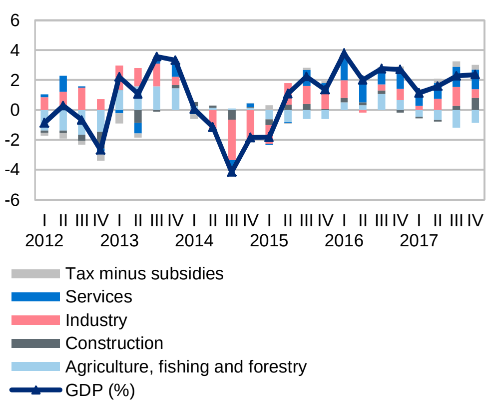
Commodity imports expressed in euros rose by 13.4% in 2017, largely on account of elevated imports of equipment (9.8%) and intermediate goods (16.4%). Furthermore, a gradual recovery of household consumption was conducive to the rise in the imports of consumer goods (3.6%). Energy imports were up by 31.1%, driven by the rising global oil and natural gas prices, in addition to higher industry needs.

In 2017 the commodity export/import cover ratio[35] moved close to record levels achieved in 2016 and equalled 78.1% in December 2017, or 86.6% if services are also included.

9 Economic activity

Real GDP growth in 2017 stood at 1.9% and was primarily driven by the continuation of positive developments in manufacturing and intensified activity in the service sectors, which were boosted by further growth in external and recovery of internal demand. Growth slower than in 2016 is the consequence of temporary negative shocks on the supply side, which affected the fall in production, primarily in agriculture

Chart III.9.1 **Contributions to y-o-y GDP growth rate – production side**
(in pp)



Sources: SORS and NBS calculation.

[35] Measured by a 12-month moving average.

and energy. This caused a somewhat slower GDP growth in H1 (1.1% y-o-y in Q1 and 1.6% y-o-y in Q2), while the recovery of construction, coupled with sustained positive developments in the manufacturing and service sectors, contributed to faster GDP growth in H2 (2.3% y-o-y in Q3 and 2.4% y-o-y in Q4). Excluding the agriculture and energy sectors, that is, areas affected by the mentioned shocks, GDP growth in 2017 stood at around 3%.

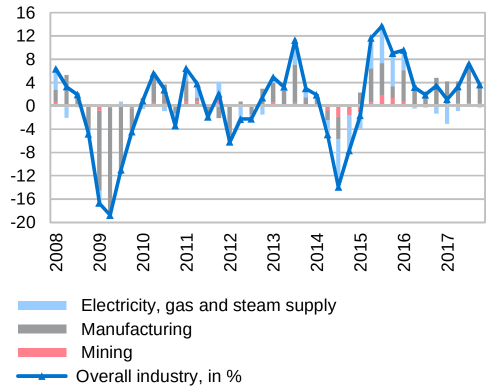
Compared to the pre-crisis level[36], economic activity at end-2017 was higher by 5.0% measured by GDP, or by 7.1%, measured by NAVA.

Industrial production in 2017 grew by 3.5% and had a positive contribution to GDP with 0.7 pp, mainly as a result of persistent favourable tendencies in manufacturing, affected by the past investment activation and lower costs of borrowing, on the supply side. Faster growth in the euro area and growth of other important foreign trade partners were the demand-side factors. In 2017 the expansion of the physical volume of production in manufacturing of 6.3% remained broadly dispersed, since it occurred in 19 out of 24 areas, the greatest contribution coming from the production of machinery and equipment, rubber and plastic products, chemical products and metal products. In addition to manufacturing, the mining sector also recorded expansion of the physical volume of production (2.2%) in 2017. After a fall in Q1, caused by the negative effects of cold weather, it grew in the remainder of the year. On the other hand, unfavourable hydrological situation had a negative effect on the production in the electricity, gas and steam supply sector which dropped by 6.2%

A positive contribution to GDP of 0.2 pp originated from **construction**, whose growth accelerated to 5.5% in 2017. After a sluggish start of the year, partly due to cold weather, since Q3, construction has been recovering

Chart III.9.3 **Contributions to y-o-y growth of the physical volume of industrial production**

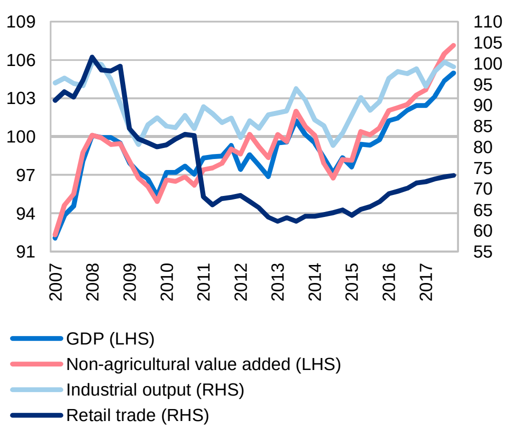
(in pp)



Sources: SORS and NBS calculation.

Chart III.9.2 **Economic activity indicators**

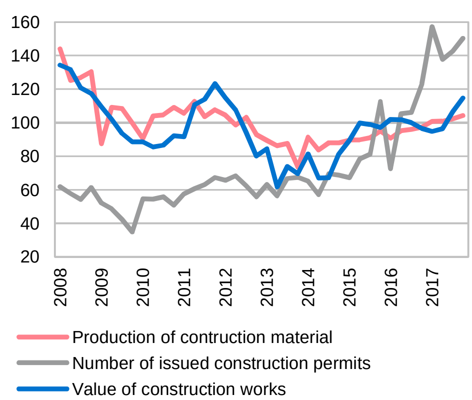
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Chart III.9.4. **Construction activity indicators**

(s-a, 2016 = 100)



Sources: SORS and NBS calculation.

[36] Level from H1 2008.

owing to, *inter alia*, a faster implementation of infrastructure projects, as indicated by the pace of capital budget expenditures, which improved significantly in H2. The value of executed works in 2017 grew by 5.2% in real terms, and the production of construction materials also rose (3.5%) as well as the number of hours worked on construction sites (2.4%). The rise in construction can also be attributed to continued regulatory improvements in this area. According to the latest (2018) World Bank Doing Business Report, Serbia made additional progress in the area of issuing of construction permits and is currently ranked as the 10th in the world, out of 190 observed countries. Accordingly, the number of issued construction permits in 2017 rose by 45.8% while the anticipated value of pertinent works went up by 61.2% suggesting the continuation of growth in construction in the coming period.

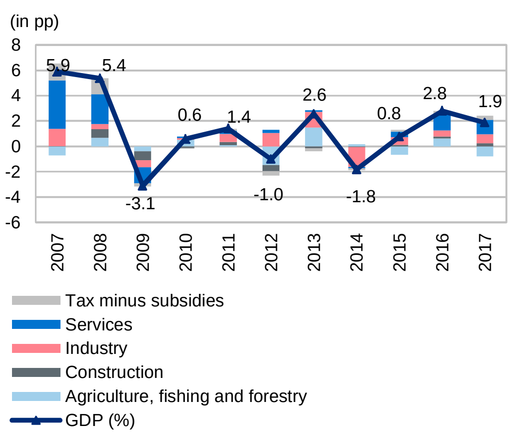
Further recovery of domestic demand had a positive effect on **service sectors** activity, which grew by 2.2% in 2017 with a positive contribution to GDP growth of 1.1 pp. The greatest contribution came from trade (0.5 pp), as indicated by 3.7% real growth of retail trade turnover. In addition, positive developments continued in the sector of accommodation and food services, which is suggested by a higher turnover in catering (7.7%) and the number of tourist arrivals (12.1%) and their overnight stays (10.5%). Also, a more intensified activity in the transport sector is indicated by the rising physical volume of transport of 8.7%, while increased turnover of telecommunication services and exports of computer and information services suggests the rise in information and communications sector.

On the other hand, due to adverse weather conditions throughout most of the agricultural season, the yields of all main crops were lower, consequently leading to a **fall in agricultural production** by 9.5% and its negative contribution to GDP of 0.8 pp. Corn production recorded the sharpest fall (45.5%), mostly affected adversely by the drought, while the production of wheat and soybean decreased to a lesser extent (21.0% and 20.0%, respectively). Fruit production also dropped, with the production of all main fruits falling (plums, apples, raspberries), while viticulture expanded.

10 Wages and employment

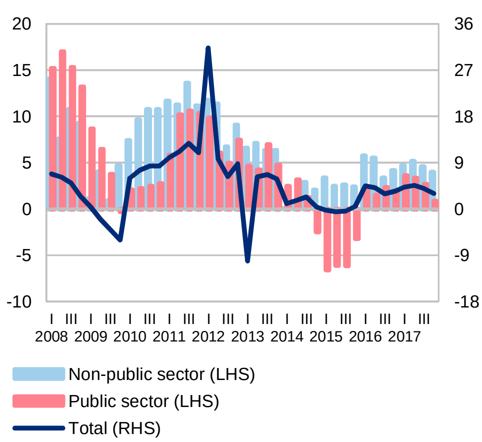
Continued economic growth and increase in the minimum wage lifted the nominal net wage by 3.9% in 2017. At the same time, as in the past years, total wage increase was primarily driven by the higher average private sector wage (4.6%), while wage increase in a part of the public sector contributed to a rise in the average public sector wage by 2.6%. Wage increase in the private sector, which was faster than in the public sector, narrowed the gap between average wages in the two sectors in 2017 to around 3% on average.

Chart III.9.5 **Contributions to annual GDP growth rate – production side**



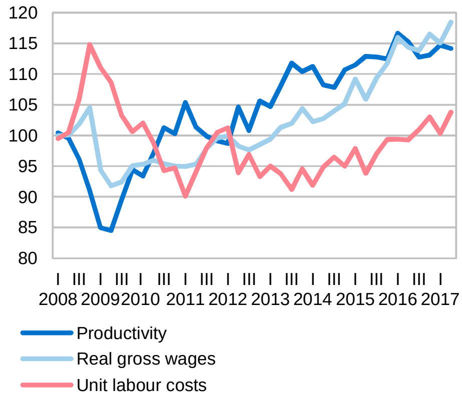
Sources: SORS and NBS calculation.

Chart III.10.1 **Nominal net wages**
(y-o-y growth rates)



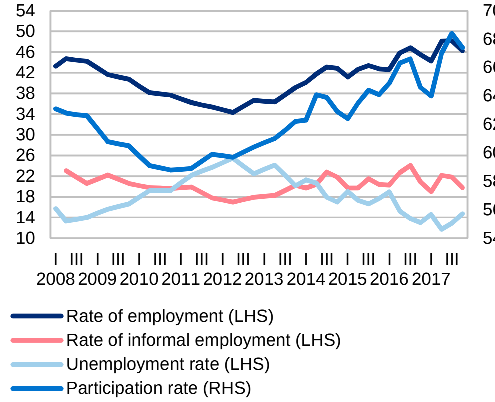
Sources: SORS and NBS calculation.

Chart III.10.2 **Productivity, real gross wages and unit labour costs in manufacturing**
(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.

In 2017 the nominal wage rose in all economic sectors, with production in manufacturing, information and communications, accommodation and food services, and trade (i.e. sectors which contributed to GDP growth to the greatest extent) rising more than the average for economy. Higher average wage, coupled with employment growth, contributed to a rise in the total nominal net wage bill by 6.6%, with the rise being more prominent in the private (9.2%) than in the public sector (1.1%). Average nominal net wage in the Republic of Serbia in 2017 amounted to RSD 47,893, up by 3.9% relative to 2016.

As the physical volume of production (6.4%) grew faster than employment (6.0%), productivity in manufacturing kept rising in 2017 as well. Nevertheless, this growth was lower than the growth of gross real wages (2.9%), which consequently led to the rise in unit labour costs by 2.5%.

In addition to wage increase, the continuation of favourable labour market trends in 2017 is also indicated by a further employment rise and elevated participation rate, as well as the reduction in unemployment. According to the **Labour Force Survey**, the average employment rate in 2017 was 46.7%, up by 1.5 pp relative to 2016. This rise in employment was entirely driven by favourable developments in the formal segment of the labour market, while the informal employment rate was cut by 1.3 pp to 20.7%. In terms of economic sectors, industry and services recorded higher employment and largely contributed to GDP growth, while agricultural employment dropped, partly due to poor agricultural season.

Central Registry of Mandatory Social Insurance data also indicate rising formal employment. Namely, according to the Central Registry, formal employment was up by 2.5% in 2017. Such growth resulted from a rise in the number of people employed by legal entities and the number of entrepreneurs and their employees, while the number of individual agricultural producers fell. Formal employment rose in manufacturing, most of the service sectors and construction, which is in line with the Labour Force Survey data. On the other hand, agriculture recorded lower employment, as did the mining and energy sectors, financial sector and public administration.

According to the Labour Force Survey, the average unemployment rate in 2017 was 13.5%, down by 1.8 pp relative to 2016. Unemployment contracted in conditions of a rising participation rate[37], i.e. increase in the size of the labour force, from 65.6% in 2016 to 66.7% in 2017. Unemployment fell among all age groups, with the reduction of 3.0 pp among younger generation (15–24), while the NEET rate[38] was down by 0.5 pp on average and stood at 17.2%. Additionally, the long-term unemployment rate also preserved the downward trend (1.8 pp) and stood at 8.2% on average in 2017.

The National Employment Service data also recorded unemployment drop in 2017. In December 2017,

[37] Labour force activity rate, measured as the share of active population (employed and unemployed people) in the total working age (15–64) population.

[38] The share of people aged 15–24 not in employment, education or training in the total population belonging to the corresponding age group.

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

	2017			
	Q1	Q2	Q3	Q4
Total number of formally employed	2.9	2.7	3.1	2.5
Employed with legal persons	2.5	2.4	2.9	2.3
Entrepreneurs and their employees	6.6	5.9	5.7	5.6
Individual farmers	-3.6	-3.9	-4.6	-6.6
Unemployed persons	-8.2	-8.7	-9.0	-11.7
First-time job seekers	-9.0	-9.4	-9.8	-12.4
Used to be employed	-7.7	-8.3	-8.6	-11.4

Sources: SORS and National Employment Service.

unemployment stood at 642,518, down by 82,120 unemployed persons relative to 2016. As in the previous period, occupations related to manufacturing (mechanical engineering and metal processing), trade and tourism and catering recorded the sharpest fall in unemployment.

The expected acceleration of economic growth and continued improvement of business environment should have a positive effect on the increase in employment and wages and unemployment reduction in the coming period.

Appendix 1 Monetary Policy Programme of the National Bank if Serbia in 2018

Monetary Policy Programme of the National Bank if Serbia in 2018

1. Pursuant to the Law on the National Bank of Serbia, the primary objective of the National Bank of Serbia and its monetary policy is to achieve and maintain price stability, which contributes to the preservation of stability of the financial system and sustainable economic growth.

2. In 2018, the National Bank of Serbia will conduct its monetary policy pursuant to the Memorandum of the National Bank of Serbia on Inflation Targeting as Monetary Strategy[1] and the National Bank of Serbia's Memorandum on Inflation Targets until 2020.[2]

3. The monetary policy objective of the National Bank of Serbia is expressed numerically as the **annual percentage change in the consumer price index** and is set at 3.0%±1.5 percentage points for 2018. The target was lowered to 3.0% as of the beginning of 2017, which confirms the commitment of the National Bank of Serbia to preserve price stability in the medium run, together with the Government. In this way, the National Bank of Serbia contributes to improvement in the business and investment climate, a reduction in long-term dinar interest rates and a greater use of the dinar in financial transactions, and thus to lower costs of funding and reduced exposure to the currency risk of the corporate, household and government sectors.

4. The National Bank of Serbia will aim to achieve the defined inflation target by using the interest rate in main open market operations as its key monetary policy instrument. In 2018 as well, the National Bank of Serbia will change the level of this interest rate in a consistent and predictable manner, taking into account the inflation projection, economic developments in the domestic and international environment, and the impact of these changes on financial stability. In addition, if the need arises, the National Bank of Serbia will make use of other instruments under its remit in order to achieve the inflation target in the medium run, taking account of the stability and resilience of the financial system.

5. The National Bank of Serbia will continue to pursue the managed floating exchange rate regime. It will intervene in the foreign exchange market to ease excessive short-term volatility of the exchange rate, preserve price and financial stability, and maintain an adequate level of foreign exchange reserves.

6. In addition to monetary policy instruments, the National Bank of Serbia has at its disposal macroprudential policy instruments, whereby, without prejudice to its primary objective, it contributes to the preservation and strengthening of stability of the financial system. The National Bank of Serbia will continue to implement regular testing of the resilience of the financial system to potential macroeconomic risks. The selection of a concrete macroprudential instrument is part of a wider process of identifying and measuring the systemic risk, which will be further improved.

7. The National Bank of Serbia will make monetary policy decisions and undertake activities in the field of microprudential and macroprudential policies in the manner which ensures the maintenance of low and stable inflation, the preservation of financial stability, and support to the implementation of economic policy of the Government.

8. The implementation of the NPL Resolution Strategy has resulted in a significant drop in the share of non-performing loans (NPLs) in total bank loans, and will continue to contribute to their further decline in 2018. This should additionally contribute to growth in lending, strengthening of the credit channel and more effective transmission of monetary policy measures to the real sector.

[1] Adopted at the meeting of the NBS Monetary Policy Committee of 22 December 2008.
[2] Adopted at the meeting of the NBS Executive Board of 7 December 2017.

9. Successful implementation of fiscal consolidation and structural reforms, and full coordination of monetary and fiscal policy measures helped narrow internal and external imbalances and increase the resilience of the domestic economy to potentially adverse effects from the international environment. Having in mind uncertainties stemming from the international environment, in 2018 the National Bank of Serbia will maintain caution in making monetary policy decisions.

10. In an environment of low and predictable inflation and a relatively stable exchange rate, the National Bank of Serbia will continue to implement the dinarisation strategy in order to reduce the exposure of the corporate, household and government sectors to the currency risk, while at the same time increasing the efficiency of monetary policy instruments.

11. In accordance with the principles of transparency and accountability, and with a view to anchoring inflation expectations within the target band, the National Bank of Serbia will communicate with the public through a) press releases, b) press conferences, c) the Inflation Report, d) the Financial Stability Report, and e) other publications.

Appendix 2 National Bank of Serbia's Memorandum on Inflation Targets until 2020

NATIONAL BANK OF SERBIA'S
MEMORANDUM
ON INFLATION TARGETS UNTIL 2020

To define the framework for medium-term monetary policy decision-making and to anchor and stabilise inflation expectations, the Executive Board of the National Bank of Serbia hereby sets the inflation target for 2019 and 2020.

In accordance with the Agreement between the National Bank of Serbia and the Government of the Republic of Serbia on Inflation Targeting and the Memorandum of the National Bank of Serbia on Inflation Targeting as Monetary Strategy, pursuant to which the National Bank of Serbia committed to set inflation targets in cooperation with the Government, the Executive Board of the National Bank of Serbia hereby sets the **headline inflation target (with a tolerance band), measured as an annual percentage change in the consumer price index**, for the period from January 2019 to December 2020 at the level of 3%, with a tolerance band of ±1.5 percentage points.

The inflation target for 2019 and 2020 will continue to be slightly above the quantitative definition of price stability and the inflation targets of advanced economies (2.0% or 2.5%). The defined inflation target results from the assessment that the process of nominal, real and structural convergence to the European Union will not be completed until 2020.

It should be borne in mind that the inflation target is a medium-term objective, i.e. that actual inflation may deviate from the target in the short run due to exogenous shocks. The National Bank of Serbia will allow temporary deviations from the target if bringing inflation back to the target in the short run warrants monetary policy changes that would trigger additional macroeconomic shocks. This relates to sudden changes in primary commodity prices. In cooperation with the Government, the National Bank of Serbia may change the targets set for inflation. Such changes will be made in exceptional circumstances only and will be explained by the National Bank of Serbia.

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