National Bank of Serbia

2014

January-June

SEMI-ANNUAL

MONETARY POLICY REPORT

2014

January–June

SEMI-ANNUAL

MONETARY POLICY REPORT

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

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

www.nbs.rs
Number of copies: 60
ISSN 2217-6535

Introductory note

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

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

The Semi-Annual Monetary Policy Report, January–June 2014 was adopted by the NBS Executive Board at its meeting of 11 September 2014.

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

Executive Board of the National Bank of Serbia:

Jorgovanka Tabaković, Governor

Ana Gligorijević, Vice Governor

Veselin Pješčić, Vice Governor

Diana Dragutinović, Vice Governor

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

[1] Law on the National Bank of Serbia, RS Official Gazette, Nos 72/2003, 55/2004, 85/2005 – other law, 44/2010 and 76/2012 (Article 71, paragraphs 2 and 3).

[2] RS Official Gazette, No 12/2013 (Article 46).

ABBREVIATIONS

bln – billion
bp – basis point
CEFTA – Central European Free Trade Agreement
CPI – Consumer Price Index
ECB – European Central Bank
EIB – European Investment Bank
EMBI – Emerging Markets Bond Index
FDI – foreign direct investment
Fed – Federal Reserve System
FISIM – Financial Intermediation Services Indirectly Measured
GDP – Gross Domestic Product
H – half-year
IFEM – Interbank Foreign Exchange Market
IFI – international financial institution
IMF – International Monetary Fund
LTROs – Long-term refinancing operations
mln – million
NAVA – non-agricultural value added
OFOs – Other financial organisations
Q – quarter
q-o-q – quarter-on-quarter
s-a – seasonally-adjusted
SITC – Standard International Trade Classification
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Contents

Overview

Inflationary pressures remained subdued in H1 2014. They were kept at bay by the receding cost-push pressure, notably in the production of food, as well as by the weak aggregate demand, a fall in inflation expectations and relative stability of the exchange rate. Y-o-y inflation returned within the target tolerance band in January. However, due to the drop in food prices, above all prices of unprocessed food, inflation has been moving below the lower bound of the target tolerance band since March. In fact, it plunged to 1.3% in June, its lowest level in the past 50 years. Low core inflation (CPI excluding food, energy, cigarette and alcohol prices), which measured 2.5% y-o-y in June, also indicates that the disinflationary pressures are likely to linger on for quite some time yet.

Despite low inflationary pressures in H1, the NBS exercised caution in its monetary policy decision-making, taking into account principally the geopolitical and economic risks in the international environment, but also possibly stronger-than-anticipated negative effects of the flooding on economic activity and foreign trade, and the need for additional fiscal consolidation measures. In the period under review, the key policy rate was cut by 100 bp, to 8.5%.

The international environment was marked by the impact of persisting geopolitical tensions. Their possible further deterioration, mainly with respect to the crisis in Ukraine, could generate multiple negative effects on the national economy, principally through strained export opportunities, a rise in the country risk premium and reduced capital inflow. Economic recovery of the euro area is likely to become sustainable. However, tensions over the crisis in Ukraine and the risk of deflation could slow down the budding economic growth. The ECB relaxed its monetary policy further in June, among other by introducing for the first time a negative interest rate on deposit facilities. Unlike the ECB, the Fed decided to proceed with QE tapering.

Economic activity contracted by 0.5% y-o-y in H1, largely as a consequence of the floods that hit Serbia in May, gravely affecting above all agricultural and industrial production. On the expenditure side, total final consumption and private investment declined, while a positive contribution came from net exports and government investment. GDP is expected to drop by 0.5% at year level as well due to flooding and the anticipated additional fiscal consolidation measures that will have a negative effect on economic activity in the short term, but which constitute a precondition for long-term sustainable economic growth. Looking ahead, impetus to the economy is expected from the subsidised loan programme, works on the restoration of flood damage, and the recovery of Serbia's main foreign trade partners.

Faster y-o-y growth in exports relative to imports continued in H1 and so did the positive contribution of net exports to aggregate demand. Still, the slowing growth in real exports (11.1% y-o-y) and the rise in imports (3.2% y-o-y) are to a degree also attributable to the effects of the flooding.

Despite the negative effects of the flooding on foreign trade, external imbalances narrowed down further. The current account deficit, under BPM6, amounted to 5.8% of GDP in H1, which is 1.1 pp less than in the same period a year earlier.

Even though they declined from end-2013, foreign exchange reserves remained at an adequate level. At end-June, they amounted to EUR 10.1 bln and covered around seven months of imports of goods and services.

The fiscal deficit came at 6.0% of GDP (7.6% including below-the-line expenses). Revenue fell short of the plan, while expenditure was in line with the level envisaged by the Budget Law. In the coming period, public finances will be additionally weighed down by the need to restore flood damage. The flooding also delayed the budget revision. However, several laws were adopted in the meantime and their application is expected to improve the business environment and bolster investment in Serbia.

In H1, the dinar weakened against the euro by a nominal 1.0% end-of-period or by 1.2% on average. The dinar's weakening early in the year was caused by both local and global factors. Even though the current account deficit was low, in an environment of modest FDI inflow, depreciation pressures were fuelled primarily by increased corporate demand for foreign exchange, notably that of energy importers. Albeit anticipated, the Fed’s decision to start QE tapering as of January caused a temporary increase in the risk premiums and gave rise to depreciation pressures across the region. Depreciation pressures were at their strongest in January. Moderate appreciation pressures emerged from late March, largely on the back of non-resident investment in government securities which gathered pace in conditions of globally decreasing risk aversion and further monetary accommodation by the ECB. By the end of June, however, depreciation pressures on the dinar renewed amid mounting geopolitical tensions and unfavourable news regarding the pace and scope of fiscal consolidation at home.

Price stability being a key ingredient to sustainable economic growth, the NBS remains firmly committed to keeping inflation low and stable over the medium run, which should be facilitated also by the better anchoring of inflation expectations. Based on NBS projections, y-o-y inflation will return within the target tolerance band (4±1.5%) until the end of the year, chiefly in response to the gradual waning of the disinflationary effect of food prices. Low aggregate demand will remain the key disinflationary factor in the medim run and its impact will be reinforced by the anticipated fiscal consolidation measures. The Executive Board expects that the implementation of additional fiscal consolidation measures and structural reforms will contribute to increasing the resilience of the domestic economy to external shocks, help reduce external imbalances and exert a positive influence on Serbia's perception among investors. An arrangement with the IMF would serve as an additional assurance of the credibility of the domestic economic policy.

I. Monetary policy framework

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

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

The inflation target of the NBS is defined in terms of the headline inflation rate (with a tolerance band) measured as the annual percentage change in the Consumer Price Index (CPI). To define the framework for medium-term monetary policy decision-making and to anchor inflation expectations, the NBS Executive Board adopted in October 2013 the inflation targets until end-2016.[4] Inflation targets are set as point targets with a tolerance band.

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

It should be borne in mind that the inflation target is a medium-term objective, i.e. that the actual inflation outturn may diverge from the target in the short run due to exogenous shocks. As so far, the NBS will allow inflation to temporarily diverge from the projected path if returning it to the target in the short term would require monetary policy changes that could cause additional disruptions to macroeconomic processes. This also applies to shocks in primary commodity prices or deviations from the planned growth in prices under direct or indirect government regulation.

The NBS strives to achieve the targeted rate of inflation through changes in its key policy rate, which is the interest rate applied in the main open market operations. This interest rate represents the key monetary policy

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

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

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 financial markets, without jeopardising stability of the financial system.

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

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

II. Monetary policy and achievement of the inflation target

1. Monetary policy January–June 2014

Monetary policy easing continued in H1 2014, though at a cautious pace. The key policy rate was cut by 100 bp in total, to 8.5%.

Consistent with NBS expectations, inflation returned within the target tolerance band in January. Inflationary pressures were low and inflation expectations declined. The inflation rate reflected past monetary policy measures, the absence of major cost-push pressures and low aggregate demand. As unprocessed food prices fell more than expected, inflation slipped below the lower bound of the target tolerance band in March.

Since the effect of monetary policy measures comes with a lag, the NBS Executive Board was guided by the projected and not by the current inflation in its decision-making on the key policy rate. Therefore, **in the first four months of 2014, the key policy rate was kept unchanged at 9.5%**. Such decision was prompted mainly by the volatility in the international financial market, fuelled primarily by the Fed's decision to embark on QE tapering as of January and by the geopolitical tensions over Ukraine. The Fed's decision to start QE tapering in January prompted investors worldwide to sell off the risky assets of emerging market economies, above all those running large current account deficits. The reaction of financial markets to Fed's subsequent decisions was softer. However, the reduction of the Fed's monetary stimulus remained a potential source of increased volatility in capital flows of emerging economies. Volatility in the international market was further amplified by the geopolitical tensions over the crisis in Ukraine and uncertainties as to its impact on global economic flows. There was a risk that it could have an indirect negative impact on Serbia – through rising global prices, primarily prices of energy and cereals, i.e. through the trade and financial channels in case of deterioration in the economic situation in the countries that Serbia cooperates with the most. Besides, a possible increase in investor risk aversion and a further cutback in investors' exposure towards emerging economies would probably mean a higher risk premium and depreciation pressures for such countries, Serbia included.

As geopolitical tensions and the Fed's QE tapering did not exert a negative effect on Serbia's risk premium and foreign trade until the Executive Board's **meeting in May** and the financial market responded well to the announced fiscal consolidation measures, **the key policy rate was trimmed to 9.0%**. A **further reduction to 8.5% took place in June**, in the wake of catastrophic floods that hit Serbia. The Executive Board held the view that inflationary pressures would remain low despite the flooding. In addition to weak aggregate demand, low inflationary pressures should be underpinned by the fall and stabilisation of inflation expectations in both short and medium run and by the relative stability of the exchange rate. Besides, as the ECB increased its monetary accommodation, the Executive Board expected a pick-up in the international market liquidity and hence, subsiding of the risks stemming from abroad. The Executive Board maintained that the recent flooding would take its toll on economic activity, especially in the sectors of energy, mining and agriculture, and that the balance of payments trends would be less favourable than anticipated earlier. Nevertheless, this year again, the share of the current account deficit in GDP was expected to be lower than in the year before. A boost to the economy was expected from the new subsidised loan programme, works on the restoration of flood damage, and the recovery of Serbia's main foreign trade partners.

Though inflation and inflationary pressures are currently low, the NBS remains cautious in monetary policy decision-making, mindful primarily of the geopolitical and economic risks from the international environment, as well as of the need for additional fiscal consolidation measures.

The flood damage will warrant additional fiscal policy efforts in the coming period. Still, in order to ensure public finance sustainability, additional fiscal consolidation measures must be implemented as soon as possible. The recently adopted reform laws are the first steps in that direction. The Executive Board expects the Government to remain committed to implementing fiscal consolidation, structural reforms and measures to improve the business environment. The expected conclusion of an arrangement with the IMF should also contribute to the credibility of economic policy. Successful implementation of fiscal consolidation and structural reforms should strengthen the domestic economic fundamentals, create preconditions for a faster and sustainable economic growth, increase the economy's resilience to external shocks, and ultimately, open up the scope for further monetary policy easing.

2. Monetary policy instruments

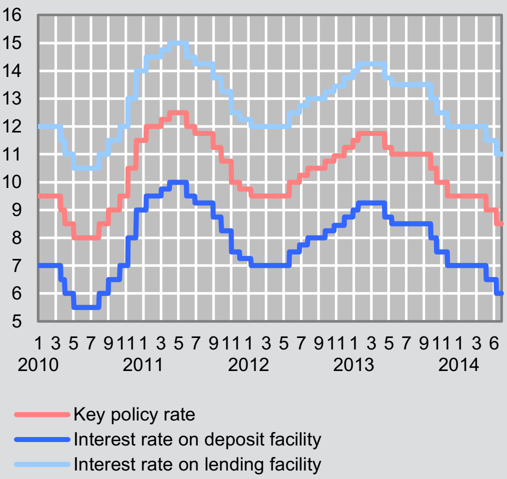
The main monetary policy instrument of the NBS is the key policy rate, i.e. the interest rate on the main open market operations. The role of the key policy rate is supported by the corridor of interest rates on deposit and lending facilities and by other open market operations. In addition to the key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

Open market operations

The main open market operations of the NBS in H1 were one-week reverse repo transactions, i.e. repo sale of securities (liquidity-absorbing).

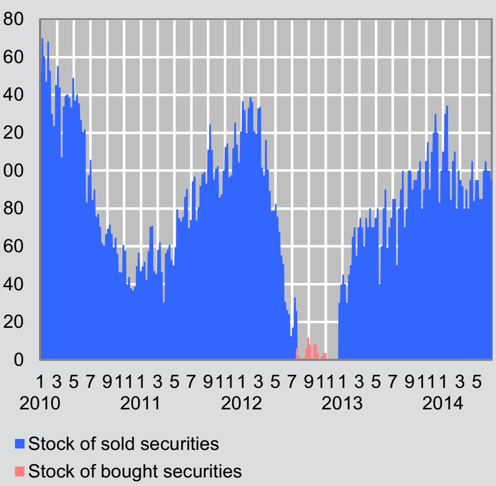
The NBS implemented reverse repo transactions by selling own securities. For these purposes, the NBS issued one series of bills in the nominal amount of RSD 500.0 bln. The issuing of one series of high nominal value is consistent with the practice in earlier years which enables a more adequate management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

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



Source: NBS.

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



Source: NBS.

There were 25 repo sale auctions in H1 2014. They were organised once a week and the securities were offered at the variable multiple interest rate. The sales totalled RSD 2,424.5 bln, slightly less than in H2 2013 (RSD 2,578.1 bln).

The stock of NBS bills in banks' portfolio averaged RSD 98.0 bln in H1. Relative to end-2013, the stock of these bills decreased by RSD 15.0 bln, to RSD 95.0 bln in late June. The decrease reflected chiefly the drop in dinar liquidity caused by the National Bank's sale of foreign exchange in the IFEM in Q1.

Deposit and lending facilities

In accordance with the Decision on Terms and Conditions of Depositing Excess Liquidity with the National Bank of Serbia, banks continued to place their excess liquidity in overnight accounts with the central bank. No amendments to this Decision were adopted in H1.

The average daily stock of bank deposits with the NBS in H1 2014 came at RSD 21.7 bln, which is RSD 1.9 bln less than in H2 2013 (RSD 23.6 bln). The highest average monthly stock was recorded in January (RSD 27.6 bln) and the lowest in March (RSD 11.9 bln).

The Decision on the Conditions and Manner of Extending Daily Liquidity Loans to Banks against Collateral of Securities, which regulates NBS lending facilities, was not amended in H1 2014 either.

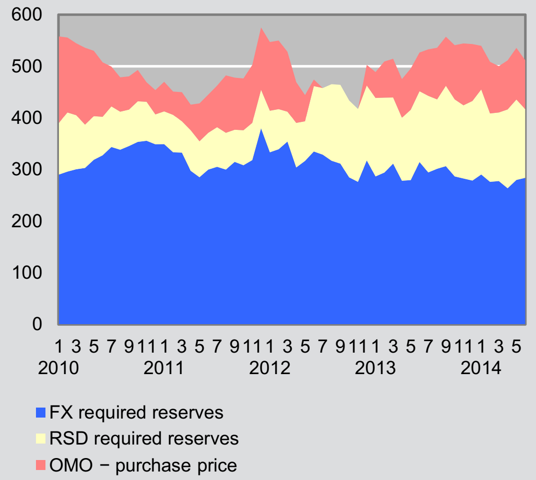
Lending facilities include intraday and overnight loans. During the period under review, banks disbursed intraday loans for ten days in the total amount of RSD 23.7 bln, while overnight loans were not drawn at all.

Reserve requirements

In 2014, the NBS continued to implement the Decision on Banks' Required Reserves, adopted in January 2011. The said Decision, which defines the reserve requirement base, applicable ratios and the currency structure of allocations, underwent no changes in H1.

The required reserve allocations in foreign currency declined by RSD 71.2 mln in H1, largely as a result of contracting components of the reserve requirement base – notably banks' FX-indexed dinar liabilities, foreign borrowing and corporate FX deposits with banks. Since a part of the required reserve is allocated in dinars, the same factors led to a decrease in the dinar required reserve (by RSD 2.7 bln). At the same time, the dinar reserve base recorded an increase, thanks principally to a continuous growth in dinar savings.

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



Source: NBS.

Foreign exchange market operations

The NBS intervened in the foreign exchange market to ease excessive short-term volatility of the exchange rate, to safeguard price and financial stability and to maintain an adequate level of foreign exchange reserves.

In H1, the NBS sold EUR 820.0 mln and bought EUR 190.0 mln in its foreign exchange interventions. The NBS intervened strictly under market conditions, as a price taker.

Depreciation pressures that swept across the market until mid-March can be put down to the seasonally higher demand for foreign exchange of domestic enterprises, notably energy importers, as well as to anxiety in the international financial markets over the prospect of further QE tapering by the Fed. In late March after the parliamentary elections, the country risk premium headed down and the dinar started picking up. The NBS responded by buying foreign exchange. Overall in Q1, the

NBS intervened by selling EUR 820.0 mln and by buying EUR 20.0 mln.

The following quarter saw an increase in non-residents' supply of foreign exchange (they sold EUR 200.7 mln net), driven by investment in dinar-denominated government securities. Continuing fall in the country risk premium in Q2 and additional measures of monetary policy relaxation by the ECB adopted on 5 June – buoyed up non-resident interest in dinar securities in the domestic market. In Q2, the NBS intervened by buying EUR 170.0 mln. By the end of June, negative news on Serbia's macroeconomic and fiscal prospects and heightened uncertainty in the international environment caused a moderate increase in non-residents' demand for foreign exchange and ushered in depreciation pressures. At end-Q2, the dinar was by 0.3% weaker in nominal terms than at end-Q1.

Compared to end-2013, the dinar was down against the euro by a nominal 1.0% at end-June.

Foreign exchange swaps

In H1, the NBS continued holding its regular three-month foreign exchange swap auctions to promote interbank swap trading and facilitate bank liquidity management. These auctions were organised on a weekly basis and under market conditions. The amount of liquidity offered was limited. To assist banks in their liquidity management, the NBS also organised two-week swap auctions. These auctions were organised once a week, under market conditions and without pre-determining the amount of foreign exchange to be sold/purchased in the auction.

In H1, the NBS held 48 three-month and 48 two-week swap auctions, buying/selling EUR 18.0 mln and EUR 31.0 mln, respectively. At the end of the period under review, NBS receivables and liabilities under three-month swaps equalled EUR 11.0 mln each, while those under two-week swaps equalled EUR 6.0 mln each.

Auctions of short-term dinar loans

To help banks maintain their liquidity, the NBS organised monthly auctions of short-term dinar loans against collateral of securities. As no demand for these loans was shown, the NBS decided to discontinue the auctions as of June.

3. Achievement of the inflation target January–June 2014

Rather low inflationary pressures, prevailing in 2013, extended to H1 2014. They were underpinned primarily by the low cost-push pressures, notably in the production of food, by the weak aggregate demand, lower inflation expectations and relative stability of the dinar.

After falling sharply in 2013 – from 12.8% in January to 2.2% in December – y-o-y inflation returned within the target tolerance band in January this year. However, because of the fall in food prices, prices of unprocessed food in particular, inflation slipped below the lower bound of the target tolerance band again in March and has been remained there ever since. In fact, it plunged to 1.3% in June, its lowest level in the past 50 years. At the same time, low core inflation[5] (inflation component most responsive to monetary policy measures) suggests that the disinflationary pressures are more durable in nature and that they are largely attributable to the stability of the exchange rate and weak aggregate demand. Core inflation

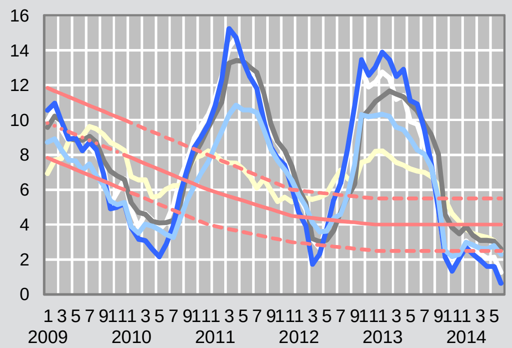
Table II.3.1 **Growth and contribution of components to consumer price growth in H1 2014**

	Growth rates (in %)	Contribution (in pp)
Consumer prices (CPI)	**2.0**	**2.0**
Unprocessed food	9.0	1.1
Processed food	0.1	0.0
Industrial products excluding food and energy	1.5	0.4
Energy	0.5	0.1
Services	1.6	0.3
Core inflation indicators		
CPI excluding energy	2.2	1.9
CPI excluding energy and unprocessed food	1.1	0.8
CPI excluding energy, food, alcohol and cigarettes	0.7	0.3
Administered prices	3.2	0.7

Source: SORS and NBS calculation.

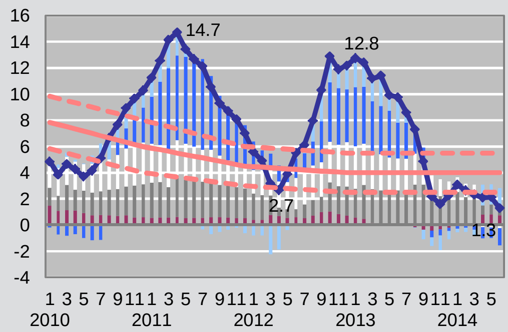
[5] CPI excluding energy, food, alcohol and cigarette prices.

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



Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

has been moving within the target band since October 2013. In June 2014, it measured 2.5% y-o-y.

Total consumer price growth in H1 2014 came at 2.0% and was driven mainly by the growth in unprocessed food prices (9.0%). These prices accounted for more than half of the total price growth in H1, i.e. they contributed 1.1 pp to inflation. Of this amount, 0.9 pp was due to fruit and vegetable prices which recorded a considerably stronger growth (12.2%) than other CPI components since the beginning of the year because of the low last year's base attributable to a very good agricultural season.

Administered prices went up by 3.2%, adding 0.7 pp to six-month inflation. Most of the administered price growth took place in Q1 as a result of adjustment to the higher VAT rate and excise tax.

Observed by quarter, consumer prices rose 1.2% in Q1, spurred primarily by the upward revision of the special VAT rate and the regular adjustment of excise tax in January. This is evidenced by the monthly inflation dynamics – following strong growth in January (1.4%), consumer prices stagnated in February (0.1%), only to fall in March (0.3%). In Q2, consumer prices rose 0.8%. Consistently with our expectations, this rise was led by the seasonal hike in prices of unprocessed food and travel arrangements.

Price stability being a key ingredient to sustainable economic growth, the NBS remains firmly committed to keeping inflation low and stable. Based on NBS projections, y-o-y inflation will return within the target tolerance band (4±1.5%) until the end of the year, chiefly in response to the gradual waning of the disinflationary effect of food prices which was rather strong in the prior period, and to a lesser degree, in response to the (anticipated) increase in electricity prices. Low aggregate demand will remain the key disinflationary factor in the medium run and its impact will be reinforced by the expected fiscal consolidation measures.

Given the weakening of inflationary pressures, the stabilisation of inflation expectations within the target band and the medium-term inflation projection, the NBS seems to be on a good path to achieve price stability in the medium run.

III. Macroeconomic environment

1. International environment

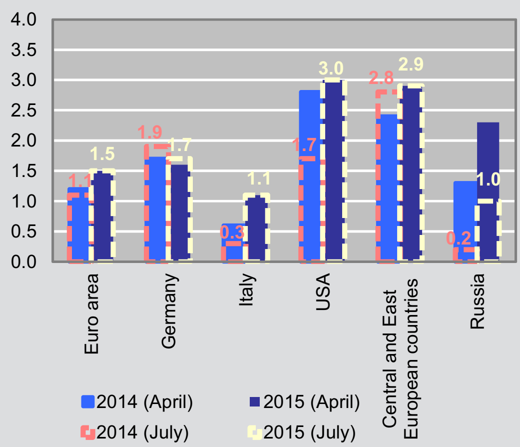
The euro area economy recorded further growth in Q1 (0.2% s-a), but stagnated in Q2. In Q1, growth was led by Germany, whose economy expanded by 0.7% s-a thanks to increased domestic investment demand. In Q2, however, the German economy contracted by 0.2% s-a as a consequence of dampened external demand. The euro area's recovery was also aided by Spain, which recorded growth for four quarters in a row after implementing tough austerity measures. The French economy, on the other hand, remained in the doldrums, while the Italian shrank in both quarters, slipping back into recession. Consensus Forecast places the currency bloc's GDP growth in 2014 at 1.1%, which is consistent with the IMF projection. Downside risks to the expected recovery of the euro area are associated with the continuation of disinflationary pressures and the deepening of geopolitical crisis in Ukraine.

As strong **disinflationary pressures** in the euro area persisted throughout H1, y-o-y inflation dropped by 0.3 pp, to 0.5% in June, well below the ECB's target of just under 2%. The ECB judges that inflation will stay low this year and for the major part of the next year, whereafter it should gradually return back to the target. Inflation's return to the target will be supported by the firmly anchored long-term inflation expectations.

The pick-up in economic activity in H1 reflected to a degree on the labour market as well. Since the beginning of the year, **the unemployment rate went down** by 0.3 pp, to 11.5% in June. Positive movements were also registered in the financial market, as evidenced by the receding yields on peripheral sovereign bonds. Furthermore, Portugal successfully exited the IMF-EU financial assistance programme in May and Greece returned to the international capital markets with oversubscribed bond issues.

By contrast to the euro area, the **US economy** contracted in Q1 by 0.5% s-a, due to the wave of extremely cold weather that hit a good part of the country in January. This contraction, however, was **offset already in Q2**, when GDP increased, according to preliminary estimates, by 1.0% s-a. Economic growth in Q2 was propped up by robust domestic demand which was partly reflected in **improved trends in the labour market**. The unemployment rate was cut by 0.6 pp, to 6.1% in June, while total non-farm payroll employment averaged

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



Sources: IMF WEO (April 2014) and IMF WEO Update (July 2014).

* Revision compared to April WEO.

233,000 per month. Fuelled by the rising energy and food prices, June inflation in the United States edged up to 2.1% y-o-y.

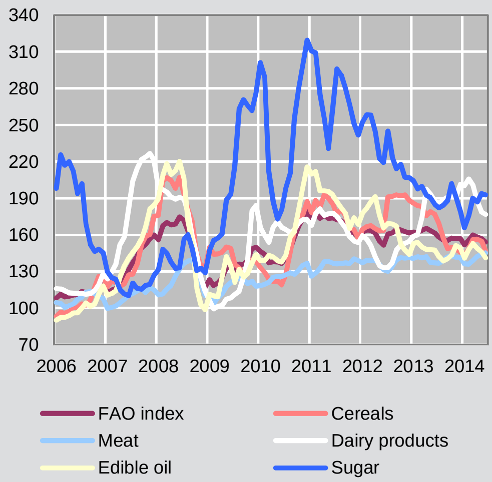
Growth projections for **Central and East Europe** were **scaled down** in H1 on account of deepening geopolitical crisis in Ukraine. According to the latest Consensus Forecast, this region is heading for 1.5% growth in 2014. Capital outflows and depreciation pressures in Russia and Ukraine took their toll on economic activity in these two countries. Due to strong trade linkages, the economic decline they experienced has affected the Baltic states and slowed down their growth. Early in the year, Turkey also faced strong depreciation pressures, which led to monetary policy tightening and will probably dampen economic growth in 2014. At the same time, the rebound of the euro area had a positive effect on the economic performance of Central European countries. In most of the Central and East European countries, **inflationary pressures** were **running low** in H1 as a result of weak demand and low prices in the euro area. The only exceptions in this respect, i.e. the countries that recorded price growth in H1, were the countries that suffered strong depreciation pressures (Russia, Ukraine and Turkey).

The **Fed**'s decision to start **QE tapering** in January was encouraged by positive signals in the labour market and an assessment that the economic growth was sustainable. This decision ruffled the financial markets, causing capital outflows and sending depreciation pressures on the currencies of emerging market economies. Still, reduced liquidity in the international financial market was moderated to a degree by the accommodative policy moves of the **ECB** which, in a bid to counter disinflationary pressures, trimmed the **main refinancing rate** in June to its historical low (0.15%), introduced a negative interest rate on deposit facilities and announced a new package of targeted LTROs.

Monetary policy implemented in Central and East Europe followed divergent paths in H1. The central bank of Hungary lowered the policy rate by 70 bp, while those of Romania and Albania did so by 50 bp. At the same time, the central banks of Ukraine and Russia raised their policy rates since the beginning of the year by 300 bp and 200 bp, respectively. In response to depreciation pressures in January, the Turkish central bank revised its policy rate upwards by 550 bp. As the flows in the foreign exchange market normalised, the rate was reduced by 125 bp until the end of H1.

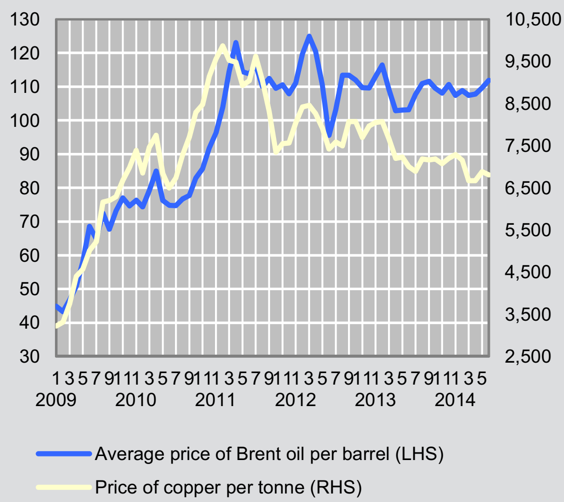
The start of monetary tightening by the Fed and favourable macroeconomic indicators for the US economy contributed to the strengthening of the dollar

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



Source: FAO, UN.

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



Source: Bloomberg.

against the euro early in the year. From February onwards, the dollar weakened vis-à-vis the euro on the release of data about the surprisingly sharp contraction of the US economy in Q1 and the delayed reduction of the ECB's main rate. This trend persisted until early May, when the ECB officials were more specific in announcing further monetary accommodation. The trend reversed and the dollar marked gains against the euro until the end of H1.

World food prices recorded a **decline**[6] in H1 owing primarily to the fall in milk and dairy prices following an output increase in the main export regions (EU and Oceania), as well as owing to the subsiding of global demand. Bright prospects for corn and wheat output brought about a decrease in cereal prices, while the announcement of a record soybean harvest lowered the prices of edible oil. On the other hand, despite the cheapening of animal feed, meat prices trended upwards as the porcine epidemic diarrhoea virus spread across the United States and weighed down on meat production. A rise was recorded also for sugar prices because of the bad weather conditions for the production of sugar cane in Brazil and India.

Brent oil price went up by 1.1% in H1 (end-of-period). Increased output of OPEC members set oil prices on a downward path from January to April, while the worsening of the geopolitical situation in the Middle East and Ukraine reversed the trend from April on. Heightened geopolitical risks and the slackening growth of the US economy caused **a rise in the price of gold**, which is traditionally regarded as a safe haven.

International copper prices in H1 mirrored the movements in demand from China, the world's largest copper consumer, and were 5.5% **lower**, end-of-period. Namely, in Q1 copper prices fell on the news of softening growth of China's economy, only to rise in Q2 on the release of positive macroeconomic indicators for China.

2. International transactions

Balance of payments and foreign exchange reserves

Improvement in the current account of the balance of payments[7] continued in H1 against the backdrop of unfavourable trends in domestic economic activity. This improvement was aided chiefly by the continuing positive trends in goods trade. Unlike the same period a year earlier, the capital and financial account experienced a net capital outflow, leading to a decrease in NBS foreign exchange reserves.

Based on preliminary data, the current account deficit amounted to EUR 865.8 mln in H1, 18.0% less than in the same period last year. Its share in GDP shrank by 1.1 pp y-o-y, to 5.8%. The narrowing of the current account deficit is attributable to the foreign trade deficit which fell by 19.6% y-o-y, to EUR 1.7 bln.

A further fall in the foreign trade deficit reflects primarily a faster growth in exports than in imports of goods and services. In H1, exports totalled EUR 7.0 bln and imports EUR 8.7 bln, up by 11.3% and 3.4% y-o-y, respectively. As a result, the exports to imports ratio increased by 9.5 pp, to 74.8%.

The growth in exports of goods continued to outpace the growth in imports (11.6% and 2.4% y-o-y, respectively). Though both export and import prices declined, export prices declined at a slower pace (5.2% and 8.1% y-o-y, respectively), which brought about a 3.1% improvement in terms of trade. At end-H1, exports of goods were 45.5% above their pre-crisis level[8].

The analysis by SITC categories and sections indicates that the growth in exports was led primarily by machinery and transport equipment (notably road vehicles) and food (above all cereals), which accounted for 40.9% and 32.0% of the y-o-y export growth in H1. A significant increase was also seen in the exports of iron and steel, petroleum products, articles of apparel and paper. Unfavourable trends were recorded in the exports of electricity and non-ferrous metals which declined by 41.8% and 11.7% y-o-y, respectively. Owing to increased exports of automobiles, automobile parts and related products, the share of exports to EU countries climbed from 64.1% in H1 2013 to 66.6% in H1 2014. Automobile exports also contributed to the increase in exports to the United States, whose share in total exports expanded by 2.5 pp, to 3.4% last year, while in H1 2014 it stayed at an approximately the same level as in H1 2013 (2.0%). The share of exports to the Commonwealth of Independent States (CIS) slid from 9.9% in H1 2013 to 7.9% in H1 2014, while the share of exports to CEFTA countries fell from 19.1% to 18.0%.

[6] FAO – Food Price Index.

[7] BoP data are presented under the new methodology (BPM6).

[8] Level recorded in H1 2008.

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

	January-June	
	2013	**2014**
I CURRENT ACCOUNT	-1,055.3	-865.8
II CURRENT ACCOUNT BALANCE, before grants	-1,106.8	-954.6
1. Goods	-2,234.7	-1,852.0
1.1 Credit	4,729.1	5,279.5
1.2. Debit	6,963.8	7,131.4
2. Services	105.4	140.0
2.1 Credit	1,524.0	1,679.9
2.2. Debit	1,418.5	1,540.0
3. Goods and services	-2,129.3	-1,712.0
3.1 Credit	6,253.1	6,959.4
3.2. Debit	8,382.4	8,671.4
4. Primary income	-486.3	-618.0
4.1 Credit	280.8	243.5
4.2. Debit	767.0	861.5
of which: interest	55.9	33.5
5. Secondary income	1,560.2	1,464.2
5.1 Credit	1,736.6	1,640.5
of which: grants	83.4	112.3
5.2. Debit	176.4	176.2
III CAPITAL ACCOUNT	9.1	0.7
IV FINANCIAL ACCOUNT (excluding reserve assets)	-942.2	286.2
1. Direct investment, net	-435.1	-537.0
1.1 Net acquisition of financial assets	117.5	65.4
1.2. Net incurrence of liabilities	552.5	602.4
2. Portfolio investment, net	-1,055.1	-145.7
2.1 Net acquisition of financial assets	38.9	4.9
2.2. Net incurrence of liabilities	1,094.0	150.6
3. Financial derivates, net	0.2	-2.3
3.1 Net acquisition of financial assets	-4.4	-1.8
3.2. Net incurrence of liabilities	-4.6	0.5
4. Other investment, net	547.7	971.2
4.1 Trade credit and advances, net	-85.7	28.9
4.1.1. Net acquisition of financial assets	327.9	378.5
4.1.2. Net incurrence of liabilities	413.6	349.6
4.2. Financial loans, net	670.2	680.6
4.2.1. Net acquisition of financial assets	-26.3	-40.3
4.2.1.1. Long-term	-30.3	-40.4
4.2.1.2. Short-term	4.1	0.0
4.2.2. Net incurrence of liabilities	-696.5	-720.9
4.2.2.1 Long-term	-527.4	-676.1
4.2.2.2. Short-term	-169.0	-44.8
4.3. Currency and deposits, net	-38.0	261.7
4.3.1. Net acquisition of financial assets	-77.0	217.9
4.3.2. Net incurrence of liabilities	-39.0	-43.8
4.4. Other	1.2	0.0
V Reserve assets	-26.4	-1,170.4
VI NET ERRORS AND OMISSIONS	77.6	-19.1
VII OVERALL BALANCE	26.4	1,170.4

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

The growth in imports slowed down under the influence of low domestic demand and falling import prices. Almost all SITC categories showed a decrease in imports relative to the same period a year earlier. The sharpest decrease was registered in the imports of machinery and transport equipment. The drop in imports of this product grouping reflects a fall in nearly all sections except automobile production components, which continued to grow, signalling further expansion of automobile production and exports. A considerable decline was also noted in the imports of chemical products, notably fertilisers. Observed by country, the share of imports from the EU increased from 62.7% of total imports in H1 2013 to 64.0% in H1 2014, while the share of imports from the CIS stayed broadly unchanged (13.9%). Imports from CEFTA countries contracted and so did their share in total imports – from 4.7% in H1 2013 to 4.1% in the same period of this year.

Surplus on trade in services continued to provide a positive contribution to the current account balance. In fact, it rose on H1 2013 by 32.7%. This rise can be put down in particular to telecommunications, computer and information services and processing services. Transport and travel, as the key items of the exports and imports of services, posted a deficit, though smaller than in the same period a year earlier.

The deficit on the primary income account went up by 27.1% y-o-y, to EUR 618.0 mln in H1 2014 as a consequence of higher net payments in respect of income from direct and portfolio investments. As regards direct investment income on equity capital, payments rose to EUR 390.0 mln (by 35.4% y-o-y) because of profit growth in this year and the high share of losses disclosed by enterprises in non-resident ownership in the same period last year. Payments on account of portfolio investment income increased to EUR 199.8 mln (by 64.6%). On the other hand, payment of interest on financial credits decreased to EUR 219.3 mln (by 22.7%).

The surplus on the secondary income account went down by 6.2% y-o-y in H1, driven principally by the fall in the inflow of remittances to EUR 956.4 mln (by 14.0%). Though the surplus on the secondary income account was lower, thanks to the improved trade balance, its coverage of the deficit on the balance of goods and services and primary income increased to 62.8%, which is 3.2 pp more than in the same period a year earlier.

The capital and financial account (excluding changes in FX reserves) saw a net capital outflow of EUR 286.9 mln in H1 compared to the net inflow of as much as EUR 933.2 mln in the matching period of 2013 (attributable primarily to government borrowing in the international financial market through the sale of eurobonds).

Net FDI reached EUR 537.0 mln in H1 (of which equity capital – EUR 91.5 mln, reinvested earnings – EUR 150.6 mln and intercompany borrowing – EUR 291.3 mln). Foreign direct equity investments remained modest. Most FDI in this period flowed into industry, trade and financial sector. Portfolio investments generated a net inflow of EUR 145.7 mln.

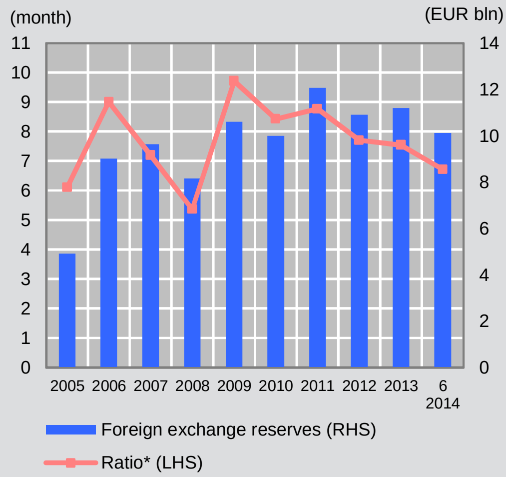
During H1 residents net repaid their financial credits by EUR 720.9 mln. The greatest part of this amount relates to the NBS and banks (EUR 375.1 mln and EUR 343.9 mln, respectively). The government net repaid its debt by EUR 61.1 mln, while enterprises net borrowed EUR 59.2 mln.

The above movements in the current and financial account brought about a EUR 1.2 bln decrease in NBS FX reserves in H1 (excluding currency changes, changes in the market value of securities and the price of gold). At the same time, the net market effect was positive at EUR 107.0 mln, resulting in a smaller nominal fall in FX reserves of EUR 1.1 bln relative to end-2013. Thus, end-June FX reserves stood at EUR 10.1 bln, covering 6.7 months of imports of goods and services. Net FX reserves equalled EUR 7.2 bln, down by EUR 610.0 mln from end-2013.

At end-H1, foreign securities made up the largest portion of FX reserves – 72.6%, followed by FX balances in accounts abroad (NBS deposits and current accounts) – 17.7%, gold – 5.2%, foreign cash – 2.5%, and SDRs with the IMF – 2.0%. A part of FX reserves was invested in short-term securities and short-term deposits, in accordance with the liquidity principle, for the purposes of timely settlement of the NBS and government's external obligations.

Foreign exchange inflow from the sale of euro-denominated RS government securities in the domestic financial market in H1 amounted to EUR 656.8 mln. Temporary payment transactions with Kosovo and Metohija[9] produced an inflow of EUR 162.9 mln. Disbursement of credits for the Republic of Serbia provided for an inflow of EUR 61.1 mln and grants – EUR 56.3 mln. In the same period, the NBS recorded FX inflow from the redemption of foreign securities coupons (EUR 53.1 mln) and interest on deposits, SDRs, demand and current accounts (EUR 1.4 mln).

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



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

A total of EUR 560.0 mln net flowed out of FX reserves on account of the central bank's interventions in the IFEM[10]. Liabilities to foreign creditors were settled on time (EUR 410.6 mln). The payment of debt to the IMF (principal and interest) accounted for an outflow of EUR 375.7 mln, while the redemption of matured RS euro-denominated securities shook off EUR 361.2 mln from FX reserves. The servicing of old frozen foreign currency savings dragged FX reserves down by EUR 227.4 mln. Outflow on account of banks' withdrawal of higher-than-prescribed FX required reserve allocations came at EUR 135.8 mln net, while the repayment of government debt to domestic banks dragged FX reserves down by EUR 42.9 mln.

International investment position

Serbia's international investment position of a net debtor increased in H1 by EUR 847.4 mln to reach EUR 31.5 bln at end-June. The increase reflects not only a rise in net financial liabilities, but also a fall in net financial

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

[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.

assets which recorded an increase in the same period a year earlier.

Net external financial assets went down by EUR 440.7 mln, to EUR 17.5 bln at end-H1. The fall was brought about by net transactions (EUR 548.6 mln), while positive currency changes, changes in asset prices and other changes exerted an upward effect equivalent to EUR 41.9 mln, EUR 64.1 mln and EUR 1.8 mln, respectively.

In contrast to the same period a year earlier, currency and deposits of residents (banks) held abroad rose by EUR 216.7 mln, to EUR 4.2 bln, and their share in total assets climbed to 23.7%.

Foreign direct investment by residents increased by EUR 62.6 mln, amounting to EUR 2.0 bln or 11.6% of total assets at the end of H1. An increase was also recorded for trade credits and advances (EUR 378.5 mln), which amounted to EUR 1.0 bln and came to account for 5.8% of total assets.

Resident portfolio investments abroad marked modest gains (EUR 4.9 mln) and reached EUR 61.0 mln, maintaining a small asset share of 0.3%. A minor share in total assets was also recorded for resident receivables under financial credits to non-residents (0.4%), which fell by EUR 40.3 mln, to EUR 64.3 mln.

Net external financial liabilities rose by EUR 406.7 mln in H1, to EUR 48.9 bln, as a result of higher net transactions (by EUR 345.1 mln) and positive currency and other changes (EUR 45.7 mln and EUR 15.9 mln, respectively). The main changes in the structure of financial liabilities in H1 include an increase in FDI and portfolio investment liabilities and a decrease in liabilities under financial credits.

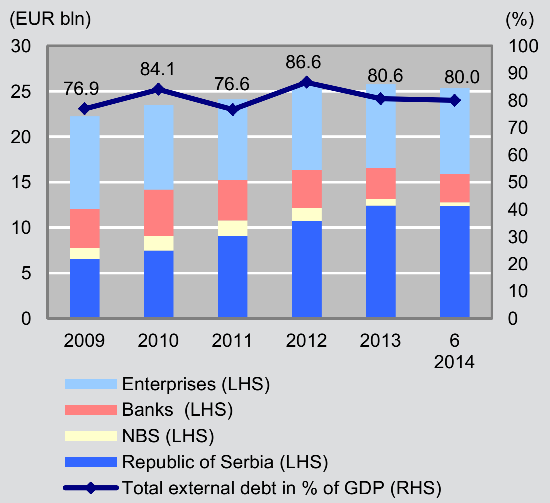
Liabilities under FDI climbed by EUR 602.4 mln, to EUR 22.8 bln, and their share in total liabilities edged up to 46.6%. At the same time, liabilities under debt instruments (EUR 318.4 mln) increased somewhat more than investments in equity capital (EUR 284.0 mln). At end-H1, liabilities under equity investments came at EUR 16.9 bln (34.6% of total liabilities) and those under debt instruments at EUR 5.9 bln (12.1% of total liabilities).

Resident liabilities under financial credits declined by EUR 703.3 mln, to EUR 17.0 bln (34.5% of total liabilities). The decline was led chiefly by the NBS and banks which net repaid their long-term credits by EUR 367.3 mln and EUR 333.9 mln, respectively, and to a lesser degree, by the government which reduced its debt by EUR 47.0 mln. Enterprises, on the other hand, increased their liabilities under financial credits by EUR 45.2 mln.

Trade credits and advances went up by EUR 352.8 mln, to EUR 1.3 bln (2.6% of total liabilities). Resident liabilities, notably government liabilities, under non-resident portfolio investments rose by EUR 194.0 mln, to EUR 6.7 bln (13.8% of total liabilities). Currency and deposits plunged by EUR 45.2 mln, to EUR 693.9 mln (1.4% of total liabilities).

Observed by sector, the share of government in total liabilities equalled 28.6% at end-June. Government liabilities included liabilities in respect of external financial loans (EUR 7.8 bln), debt securities held by non-residents (EUR 5.7 bln) and drawn SDR allocation (EUR 439.5 mln). The share of the NBS in total financial liabilities was 0.8% and consisted mostly of liabilities under long-term financial loan from the IMF. The share of

Chart III.2.2 **Republic of Serbia's net external debt by sector**



Source: NBS.

banks in total liabilities amounted to 18.6% and the share of corporates to 52.1%. Bank liabilities comprised liabilities under FDI (EUR 4.7 bln), financial credits (EUR 3.1 bln), non-resident deposits and short-term borrowing (EUR 693.9 mln) and portfolio investment (EUR 609.4 mln). Corporate liabilities comprised primarily liabilities under FDI (EUR 18.1 bln), financial credits (EUR 5.6 bln) and trade credits (EUR 1.3 bln).

The comparison of international investment positions at end-H1 2014 and end-2013 shows that total net external debt was cut by EUR 403.9 mln, to EUR 25.4 bln. Net external debt of the corporate sector increased, that of the government stayed broadly unchanged, while debts of the NBS and banks decreased. The corporate sector increased its net debt by EUR 305.1 mln, to EUR 9.5 bln. Banks, on the other hand, reduced their net debt by EUR 336.8 mln, to EUR 3.1 bln, while the NBS halved its external debt to EUR 381.2 mln at end-H1.

3. Trends in the FX market

Interest rates

By end-June, the average repo rate[11] arrived at 6.4%, down by 1.2 pp from end-2013, which implies a heftier decline relative to that in the key policy rate (1.0 pp).

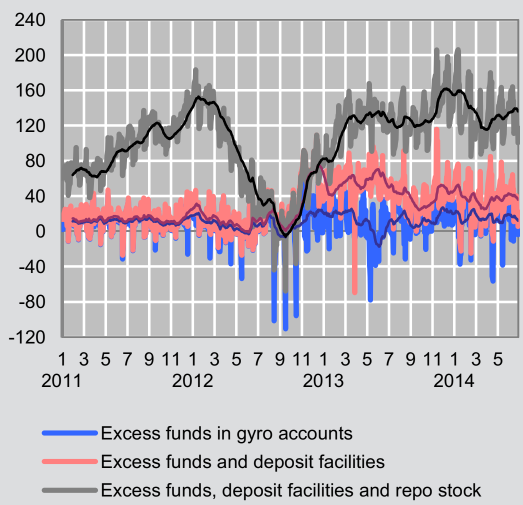
Trading volumes in the interbank overnight money market exceeded the last year's figure, equalling on average RSD 1.9 bln in H1. The average values were on an upturn until April, only to decline over the last two months of the period observed under the impact of a gradual increase in excess liquidity. Throughout H1, BEONIA mirrored the average repo rate. It touched an average 6.3% in June, down by 1.3 pp on December 2013.

BELIBOR rates showed similar dynamics – they lost between 1.1 pp and 1.4 pp. In June, they moved from 7.0% for the shortest to 8.3% for the longest maturity, on average. These were at the same time their historical lows.

Cuts in the key policy rate and elevated non-resident investment dragged down the primary market rates. The shortest maturity rates – of three and six months, recorded the steepest fall at the year-start – 1.6 pp and 1.2 pp in January and February respectively, partly under the sway of a small volume of securities offered for sale. Until the end of H1, these rates remained broadly unchanged. In contrast, longer-maturity rates were influenced by non-resident behaviour. QE tapering and tightening of geopolitical tensions weighed down on foreign investor interest in these securities in February, which pushed up these rates following the January drop. As the decline in interest was only temporary, already in the second half of March non-residents stepped up their investment. A further reduction in rates ensued in May and June in an environment of the contracted risk premium and ECB's decision on further relaxation of monetary policy. As a result, rates ranged in June between 7.7% for six-month and 11.8% for seven-year maturity. At the same time, excellent performance at H1 auctions drove up the stock of debt under sold dinar securities, despite significant amounts falling due in this period.

In H1, the government organised 12 auctions in euro-denominated securities in the local market. A ten-year euro bond was issued for the first time in April. Since early 2014, rates in this market segment were on a decline – 0.3 pp for one- and three-year maturities, and 0.2 pp for two- and five-year maturities. Rates at June

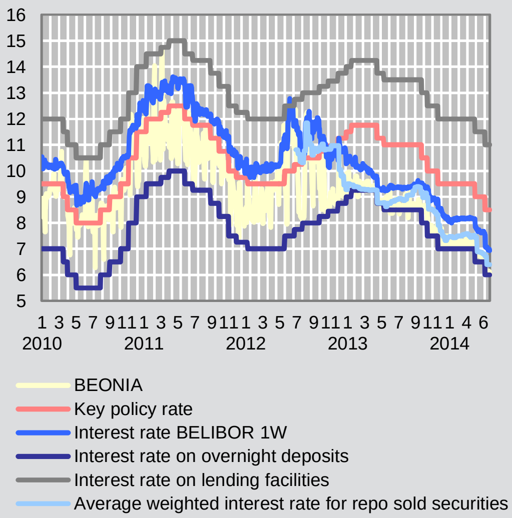
Chart III.3.1 **Dinar liquidity**
(daily stock and moving averages, RSD bln)



Source: NBS.

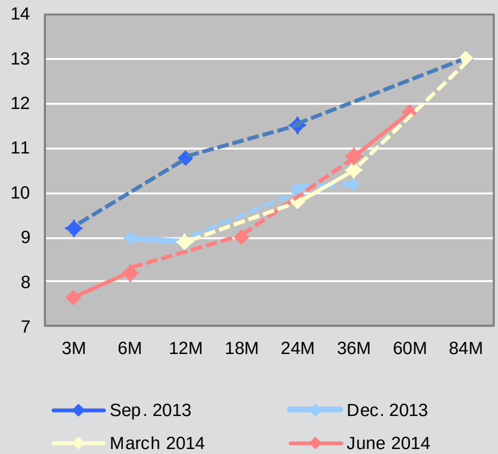
[11] The rate recorded at repo auctions, weighted by the amount of sold securities.

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



Sources: Thomson Reuters and NBS.

Chart III.3.3 **Interest rates in the primary market of government securities**
(p.a., %)



Sources: Ministry of Finance and NBS calculation for maturities not auctioned in the month observed.

auctions trended between 3.2% for one-year and 5.5% for ten-year maturity.

Rates in the secondary market of dinar securities generally mirrored the primary market rates. In the course of June, they ranged from 8.2% for the remaining 12-month to 11.5% for 81-month maturity.[12] Total trading volumes in this market amounted to RSD 116.3 bln. The most frequently traded were securities of one- and two-year maturity. Excluding trading up to two business days from the primary settlement date, trading volumes stood at RSD 77.6 bln.

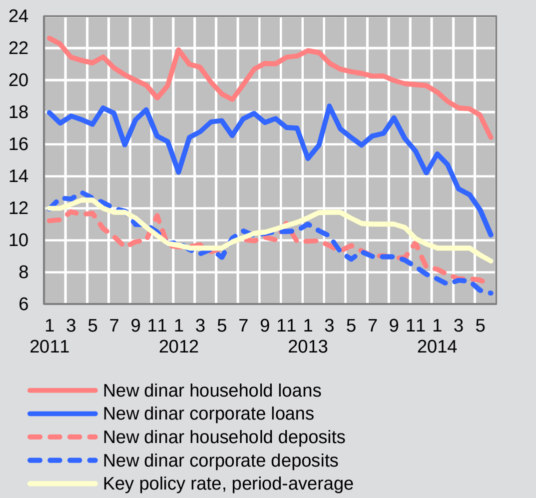
Reflecting the key policy rate, but also consistent with lower rates on dinar deposits, rates on dinar loans were on a decline almost throughout H1. The weighted average rate on new dinar loans came at 12.2% in June, down by 4.9 pp from end-2013. The drop was more pronounced with corporate loans where the average price was down 3.9 pp to 10.3%. Though declining from one month to another since February, corporate rates experienced the sharpest drop in June (1.6 pp), when banks began to extend subsidised loans at the rate capped to 5.45%, with a 5% government subsidy. Citizens also borrowed in dinars at lower rates, which fell by 3.2 pp on average to 16.4% in June. The structure of new dinar loans changed in June in favour of corporate loans (70%), which were cheaper than household loans. As a consequence, the drop in the average rate was larger than in rates on corporate and household loans separately.

Rates on all types of dinar corporate loans were on a downturn, reflecting mainly falling rates on current assets and other loans, with each category of rates equalling 10.3% in June. The decline was prompted also by reduced prices of the least used, dinar investment loans. Banks continued to lower the price of dinar household loans, most notably in Q1. The rates on cash and refinancing loans fell 3.2 pp from end-2013 to 16.4% in June. At the same time, the rates on much less popular consumer loans were down 5.5 pp to 17.9%. When the NBS began to publish in February the information on costs of current account overdrafts by individual bank, within the initiative aimed at a general reduction in prices of banking products, the average rate on overdrafts was on a decline. In June, the rate was by 1.5 pp lower compared to end-2013.

Rates on new euro loans and dinar euro-indexed loans fell by 1.0 pp relative to end-2013, reaching 5.6% in June. The fall was somewhat steeper for corporate loans at the average rate of 5.4% in June, whereas household loan rates fell to 7.0%. Similarly to dinar loans, the rates on euro-indexed current assets and other loans declined to

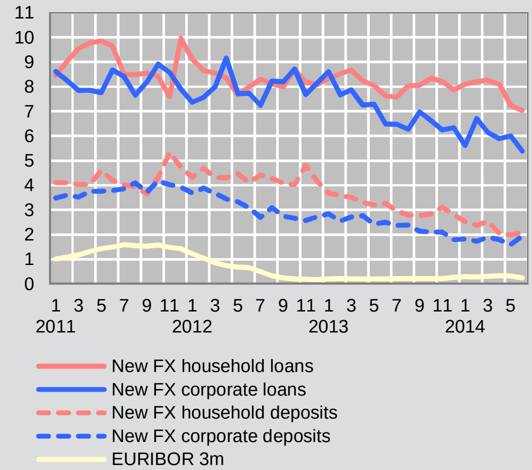
[12] Excluding the rate on seven-year securities (11.8%), which equalled the primary trading rate.

Chart III.3.4 **Interest rates on new dinar loans and new corporate and household deposits***
(weighted average values, p.a., %)



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

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



Sources: NBS and European Banking Federation.
* Excluding revolving loans, current account and credit card overdrafts.

5.1% and 6.0% respectively. A rise was noted only for the rarely used, export loans. In regard to household loans, the rates on FX housing and consumer loans went down 0.2 pp and 0.9 pp respectively, whilst the price of other loans increased slightly (0.2 pp). In late June, rates on housing, consumer and other loans equalled 4.7%, 5.7% and 10.8% respectively.

The decline in lending rates was also due to a reduction in deposit rates, as confirmed by the results of the NBS July bank lending survey, which indicate cheaper sources of bank funding. In H1, weighted average rates on new deposits recorded the lowest values since September 2010 when the current interest rate statistics came into force.

The sharpest drop was recorded for the weighted average rate on new dinar corporate deposits (by 1.2 pp to 6.7% in June), while the rate on household deposits fell 1.1 pp to 7.2%. Rates on euro household deposits went down 0.7 pp to 2.1% in June. Only the rates on corporate deposits rose a tad (by 0.2 pp to 2.0%).

Country's risk premium

In H1, risk premia of countries in the region moved mainly under the impact of news regarding monetary policies of leading central banks. Serbia's risk premium, measured by EMBI, followed the regional dynamics, though with somewhat more robust oscillations prompted by domestic factors, primarily the news on fiscal consolidation measures and the assessment of the state of public finances.

In terms of the period-end and period-average, a decline was recorded for risk premia of all countries in the region. The decline was the most pronounced for Serbia. In late June, EMBI for Serbia came at 268 bp, down by 106 bp from end-2013, with its average value by 122 bp lower than in H2 2013.

According to CDS[13] (credit default swap), Serbia's risk premium fell by 124 bp to 270 bp in late June.

Throughout the period reviewed, EMBI was on a decline in all countries of the region, except in late January when it temporarily went up in response to the Fed's decision to continue with QE tapering. Risk premia declined already in early February. The drop continued until mid-June, first under the impact of rising return on US sovereign bonds and lower return on eurobonds of the countries observed, and later due to a steeper drop in return on those countries' eurobonds than on US sovereign bonds. The largest decline was observed in May, with a mild downturn

[13] On USD five-year government bonds.

continuing into early June when the lowest EMBI was recorded in H1 over the news about ECB's further monetary accommodation. The downward trend was then halted and risk premia of most countries showed a modest rise until mid-July.

Though the Fitch rating agency lowered Serbia's credit rating to B+ in January, this had no negative effect on Serbia's risk premium. The downgrade was partly offset by the expected conclusion of an arrangement with the IMF and the start of negotiations on Serbia's EU accession. Expectations of vigorous implementation of the announced structural reforms and fiscal consolidation after the parliamentary election were also among the causes of a further decline in Serbia's risk premium.

In April, Standard & Poor's affirmed Serbia's credit rating at BB-. As appraised by the agency, the rating is constrained by the risks stemming from high fiscal deficit and external imbalance, and limited monetary policy flexibility owing to the high euroisation of the economy. Still, the rating is supported by Serbia's long-term economic growth potential, which is contingent on reforms in the labour market, business environment and public administration. Furthermore, more favourable conditions were created in which to embark on fiscal consolidation and structural reforms. Besides, in the agency's view, policy making must focus on containing any further deterioration of public finances, designated as the main reason for keeping the negative outlook.

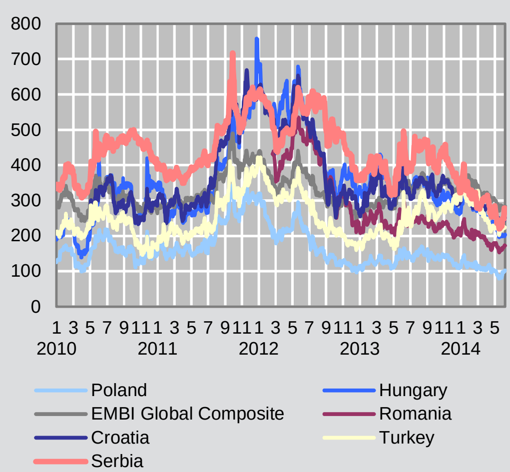
The floods that hit Serbia in mid-May did not reflect on EMBI, which was on a decline almost until mid-June, when it touched 220 bp, close to the levels last time recorded in early November 2007.

In early July, Fitch affirmed Serbia's credit rating at B+. Despite the estimate that the May floods will provoke delays, they will not jeopardise the implementation of the announced reforms and the adoption of a set of structural laws which will lay the grounds for fiscal consolidation. Expectations have also been put forward that Serbia's negotiations with the IMF about a precautionary arrangement will resume before end-2014, that GDP growth will be close to zero in 2014, and that the economy will bounce back next year. The fiscal position remains the key challenge. The deficit will widen in 2014, but is expected to narrow already in 2015.

Trends in the FX market and dinar exchange rate

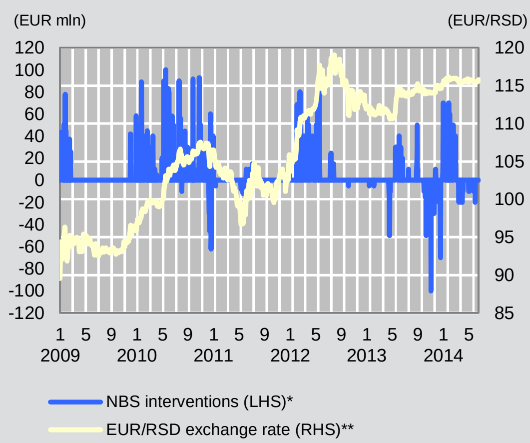
Following the January weakening, the dinar was relatively stable against the euro up until the beginning of July. Consistent with this, the dinar moved in H1 between

Chart III.3.6 **Risk premium indicator – EMBI by country**
(daily data, bp)



Source: JP Morgan.

Chart III.3.7 **Movements in EUR/RSD exchange rate and NBS FX interventions**



Source: NBS.

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

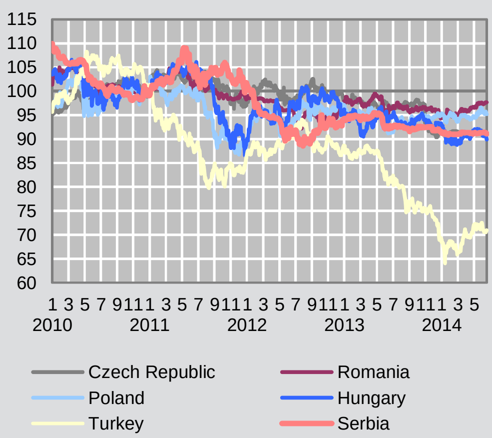
114.8 and 116.1 for one euro. The trough came about in early January and the peak in early February. By the period-end, the dinar lost 1.0% against the euro in nominal terms, but was 1.2% weaker on average relative to the previous half-year.

The dinar slipped 2.0% against the dollar period-end, but gained 0.8% in terms of period-average.

The weakening recorded in early 2014 was driven both by domestic and global factors. Despite the low current account deficit, in the setting of modest inflows from FDIs and exchange operations, depreciation pressures were caused primarily by elevated FX demand of enterprises and non-residents. Rising FX demand was of seasonal character and concerned mainly energy importers. Besides, though expected, the Fed's decision to embark on QE tapering as of January triggered a temporary rise in the risk premium and the emergence of depreciation pressures across the region, particularly in January. In that month, the dinar slid 1.1%, while other currencies depreciated significantly (some of them even despite central bank interventions). Throughout Q1, non-residents were net buyers of foreign currency – their demand most pronounced in February and the first half of March.

Q2 saw moderate appreciation pressures, largely under the impact of increased non-resident investment in government securities. In an environment of the global reduction in risk aversion and the expected further monetary accommodation by the ECB, in May and June foreign investors bought considerable amounts of dinar government securities in the primary market. As a result and in contrast to Q1, non-residents were net sellers of foreign currency in Q2. FX supply in the domestic market was higher also owing to the higher inflow from exchange operations, but partly also thanks to FDIs. These factors also induced moderate appreciation pressures during the major part of Q2.

Chart III.3.8 **Movements in exchange rates of national currencies against the euro***
(daily data, December 31, 2010 = 100)



Sources: NBS and websites of central banks.
* Growth indicates appreciation.

The dinar was stable up to July when depreciation pressures emerged over heightened geopolitical tensions, particularly in relation to the Ukrainian crisis, but also unfavourable news as to the intensity and pace of fiscal consolidation in the coming period.

Trading volumes in the IFEM continued to contract in 2014. Average daily trading volumes among banks[14] amounted to EUR 20.7 mln in H1, half of the amount in the same period last year. Exchange rate volatility[15] also reflected the trends in the IFEM, i.e. it declined further.

Guided by the assessment that depreciation pressures did not reflect a long-term tendency, but were of temporary nature, the NBS intervened in the IFEM selling EUR 820.0 mln from early 2014 until mid-March. From late March and through Q2, it intervened only on the purchase side with EUR 190.0 mln.

Stock exchange trends

Unlike indices of other stock exchanges in the region, which displayed robust changes in both directions, indices of the Belgrade Stock Exchange (BSE) recorded a constant moderate increase throughout H1. By end-June, the index of the most liquid shares BELEX15 amounted to 569.8 points, up by 2.1% from end-2013. BELEXline, the general index of shares, saw a more solid rise – 2.5% to 1,132.4 points.

Total trading in BSE shares came at RSD 9.0 bln in H1. The highest value was recorded in January (RSD 4.6 bln), largely reflecting the trading in open market[16] shares. Of total trading in shares, RSD 6.6 bln pertained to trading in the most liquid shares.

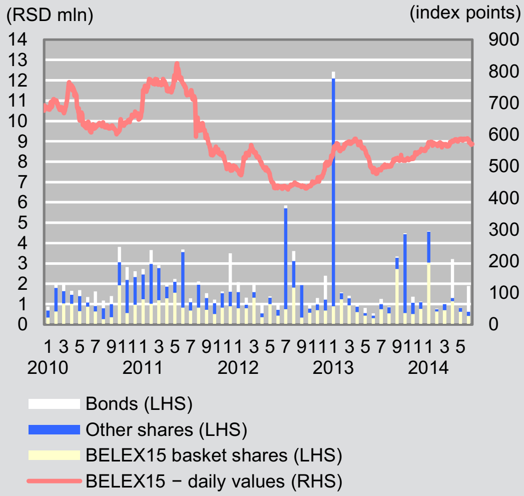
Foreign investors were net sellers of shares worth RSD 1.2 bln, on account of the January net sale. In the months

[14] Excluding the NBS.

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

[16] A part of the regulated market, consisting of shares not eligible for admission to BSE listing.

Chart III.3.9 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

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

	Dec. 2013	June 2014	Changes in H1 2014
Net foreign assets	**1,204,030**	**1,135,716**	**-68,314**
Net FX reserves	1,202,618	1,133,708	-68,910
Gross FX reserves	1,282,707	1,172,369	-110,338
IMF loans	-80,089	-38,661	41,428
Other net foreign assets	1,412	2,008	596
Net domestic assets	**-562,321**	**-524,579**	**37,742**
Net domestic NBS loans	-348,660	-296,974	51,686
Net loans to government[1)]	-236,121	-196,803	39,318
Government loans	1,166	1,163	-3
Government deposits	-237,287	-197,966	39,321
Net claims on banks	-109,912	-94,491	15,421
Loans to banks	120	2,142	2,022
Repo operations	-110,000	-95,000	15,000
Other securities	-32	-1,633	-1,601
Loans to non-bank financial institutions	5,245	5,327	82
Loans to other sectors	2,125	2,470	345
Term and restricted deposits	-9,997	-13,477	-3,480
Other net assets	-213,661	-227,605	-13,944
Reserve money	**641,709**	**611,137**	**-30,572**
Dinar reserve money	344,460	319,694	-24,766
Currency in circulation	122,439	114,843	-7,596
Dinar reserves of banks	199,881	171,762	-28,119
Required reserves	144,989	142,300	-2,689
Excess reserves	54,892	29,462	-25,430
Other deposits of other sectors	2	672	670
Local government deposits	22,138	32,417	10,279
FX bank deposits	297,249	291,443	-5,806

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

that followed, non-residents were more active on the buy-side than on sell-side, which may indicate an upturn in their investment in the domestic capital market.

Trading in frozen FX savings bonds amounted to RSD 3.3 bln on the back of elevated trading in Q2 – A2014-series bonds in April and A2015-series in June. The rates of return for the remaining series – A2015 and A2016, remained almost unchanged relative to end-2013, reaching 3.6% and 3.8% in late June respectively.

In H1, investors did not trade in corporate bonds on the BSE.

BSE market capitalisation contracted by RSD 30.2 bln in H1, equalling RSD 742.5 bln in late June. Capitalisation of the regulated market fell by RSD 32.3 bln to RSD 402.4 bln because A2014-series bonds fell due in May. MTP[17] capitalisation was up by RSD 2.1 bln to RSD 340.2 bln. As a result, the share of market capitalisation in estimated GDP[18] fell by 1.0 pp to 20.4% by late H1.

4. Money and loans

Reserve money

In H1, dinar reserve money declined by 7.2% and 9.0% in nominal and real terms respectively. This decline, along with a reduction in bank FX deposits with the NBS, brought about a reduction in total reserve money by 4.8% and 6.6% in nominal and real terms respectively. In absolute terms, dinar reserve money fell by RSD 24.8 bln and total reserve money by RSD 30.6 bln.

In H1, the bulk of dinar reserve money was withdrawn through NBS interventions in the IFEM (RSD 65.0 bln). The withdrawal was prompted mainly by net FX sales in Q1. From April onwards, interventions were aimed at liquidity creation, though to smaller degrees than the sales in previous months. Despite the spending from dinar and FX deposit accounts from February to May, the government embarked on liquidity absorption in H1 (RSD 5.6 bln) because of rising balances in the dinar account in June. The rise is attributable mainly to high tax

[17] 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.

[18] Estimated GDP over the last four quarters.

receipts based on final profit tax returns for 2013, excises and VAT.[19] On the other hand, payment operations with Kosovo and Metohija (RSD 18.7 bln) and somewhat lower bank investments in repo securities (RSD 15.0 bln) resulted in higher liquidity.

Within the structure of dinar reserve money, excess dinar reserves[20] declined the most in H1 (RSD 25.4 bln) because of banks' reduced gyro-account balances and lower usage of deposit facilities with the NBS. A decline was noted also for cash in circulation (RSD 7.6 bln) and required reserves (RSD 2.7 bln). It was only the balances in local authorities' accounts that went up (RSD 10.3 bln), recording a surplus since early 2014.

Monetary aggregates M1, M2 and M3

A rise in transaction deposits, notably of the corporate sector and OFOs, buoyed up the dinar segment of money supply in H1. The narrow monetary aggregate M1 increased the most – by 3.0% and 1.0% in nominal and real terms respectively. The movements in M1 fully determined growth in M2 and M3 (1.4% nominally) since both savings and term dinar deposits contracted, whereas FX deposits increased slightly relative to end-2013. In real terms, aggregates M2 and M3 fell 0.6% each.

Dinar monetary aggregates continued to record high y-o-y growth rates in H1. The growth slowed temporarily in February and March, but accelerated again in Q2. In June, real y-o-y growth in M1 and M2 reached 20.4% and 11.3% respectively. Besides, M2 went up fully under the impact M1 growth because savings and term deposits showed a y-o-y decline. The broadest monetary aggregate recorded the weakest real y-o-y rise (3.5%).

Broken down by component of money supply M3, the sharpest increase was observed for balances in demand deposits (RSD 19.2 bln), notably in accounts of enterprises within the manufacturing, mining, trade and transportation sectors. At the same time, longer-maturity dinar deposits of enterprises fell by an almost identical degree, confirming the shift of the deposit maturity structure in favour of shorter terms.

A H1 rise was also noted for OFO transaction accounts, though at the same time OFOs held smaller balances in dinar savings and term deposits, which, together with a drop in corporate deposits, brought about a decline in this category of accounts (RSD 3.9 bln).

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

	Dec. 2013	June 2014	Changes in H1 2014
Net external claims	**846,701**	**845,486**	**-1,215**
Bank net external claims	-357,329	-290,231	67,098
Net domestic assets of the banking sector	**870,180**	**894,759**	**24,579**
Net domestic loans	1,919,806	1,999,869	80,063
Net claims on government	48,890	157,462	108,572
Government loans	337,186	407,521	70,335
Government deposits	-288,296	-250,059	38,237
Claims on non-government sectors	1,870,916	1,842,407	-28,509
Households	674,534	692,409	17,875
Corporate sector	1,111,301	1,070,954	-40,347
Other financial corporations	49,809	43,593	-6,216
Local authorities	34,361	34,329	-32
Non-profit and other organisations	911	1,122	211
Other net assets	-1,049,626	-1,105,110	-55,484
Money supply M3	**1,716,882**	**1,740,244**	**23,362**
Money supply M2	547,566	555,259	7,693
Money supply M1	388,265	399,907	11,642
Currency in circulation	122,439	114,843	-7,596
Transaction deposits	265,826	285,064	19,238
Dinar savings and term deposits	159,301	155,352	-3,949
FX deposits	1,169,316	1,184,985	15,669

Source: NBS.

In an environment of record low y-o-y inflation and more favourable tax treatment, dinar household savings continued up. In H1, they increased by additional RSD 5.7 bln, reaching RSD 39.4 bln in June. In May, new series of frozen FX savings bonds fell due. This, however, did not fully translate into growth in FX household savings, which expanded EUR 54.1 mln since the beginning of the year.

In H1, growth in M3 was under the strongest impact of bank purchases of government securities. As of June, after a longer period, an upturn in lending also lent a boost to M3.

From early 2014, the ratio of money supply M3 to NBS FX reserves fell by 7.4 pp to 67.4% in June. Including

[19] High profit tax receipts were recorded owing to economic growth in 2013 and an increase in the tax rate from 10% to 15%. Excise receipts went up in response to the seasonal stocking of cigarettes prior to the regular July excise adjustment, stricter control of trading in petroleum products, the start of the sowing season and more intensive transit transport. The higher amount of collected VAT reflects high import VAT and the fact that a part of VAT refund was carried forward from June to July.

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

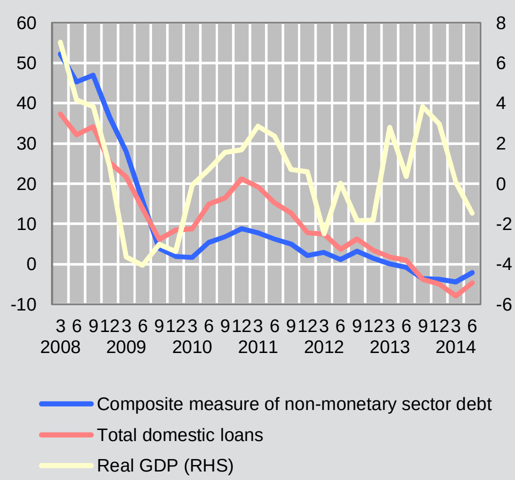
bank FX reserves, the ratio fell from 80.8% to 74.2%. Monetary multiplier increased in H1 by 0.1 pp to 1.3 and 1.7 in June for M1 and M2 respectively. A rise in transaction deposits lessened the velocity of M1 circulation. For the broader aggregates, however, the velocity of circulation remained unchanged relative to end-2013.

Bank lending

Unfavourable tendencies in lending activity continued into the first five months of 2014. Still, as of June, lending entered the recovery path owing to the new subsidised loan scheme. Namely, the y-o-y downturn in lending slowed from 7.1% in May to 4.7% in June.[21] In addition, a y-o-y decline in corporate lending slowed to 9.9% in June, while a rise in household lending continued to 4.1%.

However, despite the June recovery, domestic lending declined in H1 by RSD 20.5 bln or 1.3%, while its share in estimated GDP[22] went down by 1.1 pp to 49.0%. Such trends were driven by several factors – smaller amounts of newly extended loans, the delicensing of Univerzal banka Belgrade, the fact that earlier approved subsidised loans fell due, and the assignment of receivables to non-bank entities. After quite a while, Q1 saw an increase in enterprises' cross-border borrowing, which may also be one of the reasons behind dented demand for domestic bank loans.

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



Sources: NBS and SORS.

In H1 banks continued to rely on domestic sources of funding. Since early 2014, they cut back on investment in repo securities and also held smaller balances in dinar and FX accounts with the NBS. They also tapped dinar and FX deposits of corporate and household sectors.[23] On the other hand, they further reduced their external credit liabilities and raised their external claims. Also, they continued to invest some disposable funds in government securities.

Excluding the exchange rate effect, corporate loans fell by RSD 28.6 bln or 3.6% in H1. Moreover, negative tendencies were stalled in June when banks began to extend subsidised liquidity loans and current assets loans.[24] The disbursement of these loans amounted to RSD 28.1 bln in June, with a negligible share of refinancing loans. At the same time, banks continued to assign due receivables to non-financial persons (RSD 8.4 bln). This, together with maturing subsidised loans granted earlier, diminished the amount of loan receivables.

According to NBS bank lending surveys[25], banks tightened the standards for corporate lending in H1, considering the estimated risks relating to the collection of receivables and expectations as to the overall economic activity and the collection of collateral. On the other hand, following a decline in Q1, demand for loans, primarily by SMEs, increased in Q2. The need to restructure debts (in an illiquid economy and deteriorated collection of receivables) and the financing of current assets were the main driving forces behind the increase in demand.

Consistent with estimates presented in surveys, the majority of loans extended by banks in H1 concerned current assets and other loans. In Q2, the extension of investment loans increased as well.

Contrary to the corporate sector, bank receivables in respect of household loans increased by RSD 14.3 bln or 2.8% since early 2014. Cash loans were disbursed to the

[21] Excluding the exchange rate effect – calculated at the RSD/EUR exchange rate as at 31/08/2008, assuming that all FX and FX-indexed loans were approved in euros.

[22] Estimated GDP over the last four quarters.

[23] As the deposit base increased and lending went down, the loan-to deposit (LTD) ratio declined to 112.8% in June 2014.

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

[25] The NBS began conducting the quarterly survey in early 2014. Participation is voluntary and the response rate almost 100%.

highest extent, while housing and consumer loans were less popular. At the same time, a smaller portion of housing loans (RSD 2.8 bln) concerned the subsidised segment, i.e. the disbursement of loans extended in late 2013. Households availed somewhat less of costlier categories (credit card and current account overdrafts and revolving loans) than before.

As indicated by bank lending surveys, growth in household loans was prompted not only by additional easing of lending standards, but also by rising loan demand. Besides, banks eased the standards for the most sought-after dinar loans – cash and refinancing loans, while standards for the majority of FX loans were tightened further. The standards were eased because of cheaper sources of bank funding and increased bank competition, whilst risk perception intensified. Interest margins on dinar loans narrowed. Also, banks offered more favourable loan repayment terms along with additionally reduced accompanying costs. Demand was on a rise throughout H1, led chiefly by the need to refinance the existing obligations, while the unfavourable situation in the labour market had a negative influence on citizens' decisions to borrow.

The relatively high share of NPLs is among the factors constraining faster growth in lending activity. Under the gross principle, the share of NPLs in total loans went up by 1.6 pp in H1 to 23.0% in June. At the same time, the portion of corporate NPLs was up by 2.8 pp to 27.4%, while NPLs in the household sector rose by 0.8 pp to 10.2%.

However, despite the high NPL share in total loans, the capital adequacy ratio of around 21% is indicative of unimpaired stability of Serbia's banking sector. Allowances for impairment equalled 54.4% of NPLs in June. At 113.5% in June, loan loss provisions fully covered the amount of gross NPLs.

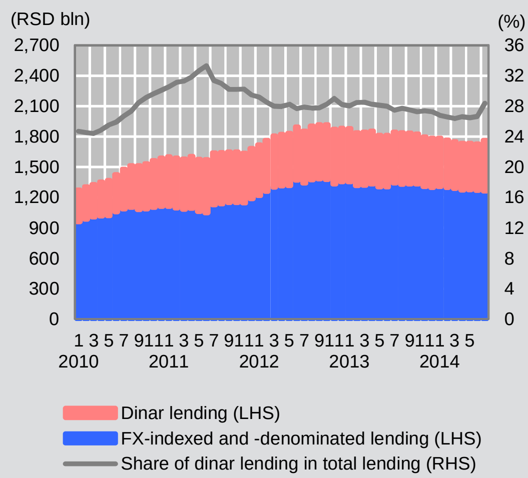
5. Dinarisation

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

Recognising the need to increase the use of the dinar in the financial system in order to strengthen the country's financial stability, lessen the exposure of the most vulnerable sectors of the economy to the currency risk, reinforce the efficiency of monetary policy and, by extension, create preconditions for strong and sustainable economic growth, in April 2012 the NBS and the Government signed the Memorandum on the Strategy of Dinarisation of the Serbian Financial System[26].

Banks are still stimulated to use dinar sources of funding, also through the required reserves policy. Required reserve ratios are still much lower on dinar compared to FX sources, and the NBS pays to banks the interest on allocated dinar required reserves only. In H1, banks

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



Source: NBS.

[26] http://www.nbs.rs/internet/english/30/MemorandumVladaDinarizacija_20120406_eng.pdf.

increased their dinar sources to a greater extent compared to FX ones. The dinar reserve base went up by 1.0%, while the FX base fell by 2.6%.

The NBS continued to support the further development of basic hedging instruments, primarily through regular three-month and two-week FX swap auctions.

The government continued to support the dinarisation of the financial system. In May 2014, the new subsidised lending programme was adopted, aimed at propping up lending activity and envisaging the subsidising of interest on dinar corporate loans without a currency clause. Moreover, when borrowing, the government relied more on dinar than FX debt instruments, which is why the share of dinar in total public debt rose from 20.9% in late 2013 to 22.3% by end-June 2014.

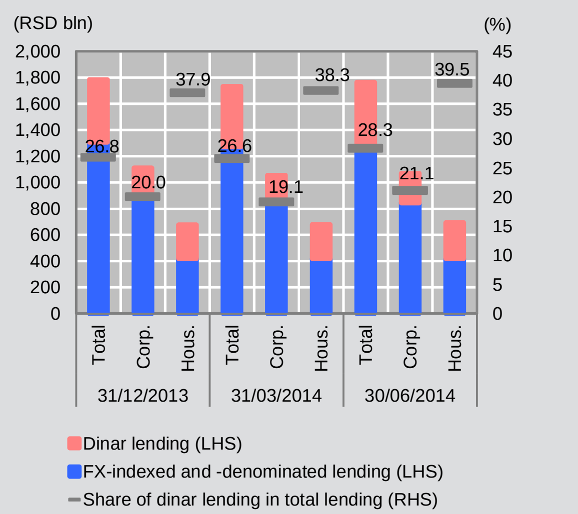
The NBS's key indicator of the financial system's degree of dinarisation is the share of dinar lending in total corporate and household lending.[27] In H1, the degree of dinarisation rose from 26.8% at end-2013 to 28.3% in late June. The higher degree of dinarisation in 2014 reflects an increase in dinar lending, most notably to the corporate sector in respect of the subsidised lending programme. At the same time, FX corporate lending declined. In parallel, the household sector continued to borrow in dinars – mainly on account of cash loans, whilst FX household borrowing stayed broadly unchanged.

As a result, the degree of dinarisation in H1 increased both in the corporate (by 1.1 pp to 21.1%) and household (by 1.6 pp to 39.5%) sectors. Excluding the exchange rate effect[28], the degree of dinarisation rose from 26.8% in late 2013 to 28.6% by end-June 2014.

6. Aggregate demand

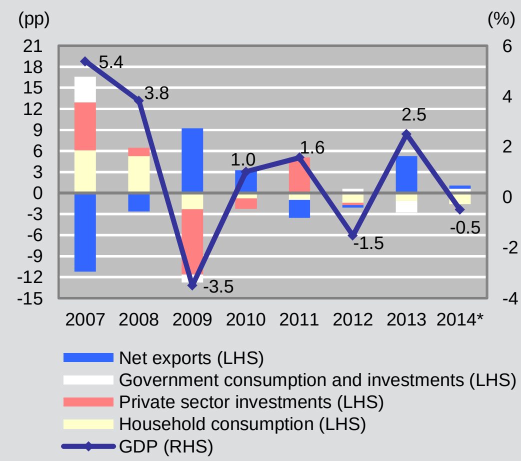
In H1, aggregate demand was by 0.5% lower relative to the same period last year. A negative contribution was provided by domestic demand – 3.5 pp, while net external demand added 3.0 pp owing to a faster rise in exports than imports. Total final consumption and private investments declined in H1, while government investment was the only component of domestic demand which recorded growth. The floods that hit Serbia in May affected negatively aggregate demand through a reduction in net exports in Q2. However, there are expectations that investments in infrastructural facilities will expand in H2 and over the next year because of flood restoration works.

Chart III.5.2 **Lending by sector**



Source: NBS.

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



Sources: SORS and NBS calculation.
*NBS estimate.

[27] See the Report on Dinarisation of the Serbian Financial System, published quarterly by the NBS on its website:
http://www.nbs.rs/static/nbs_site/gen/english/90/dinarizacija/din_06_14.pdf.

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

Table III.6.1 **GDP distribution in H1 2014**

	Growth rates (%)	Contribution to GDP growth (pp)
GDP at constant, previous year prices	**-0.5**	**-0.5**
Domestic demand	-3.0	-3.5
Total final consumption	-1.0	-1.0
Private consumption	-0.9	-0.7
Government consumption	-1.2	-0.2
Investment	-14.6	-2.5
Fixed investments	-5.7	-1.1
Private investments	-8.9	-1.5
Government investments	25.6	0.5
Change in inventories	-	-1.4
Net exports (exports - imports)	17.9	3.0

Sources: SORS and NBS calculation.

Domestic demand

The implementation of fiscal consolidation measures in H2 2013 impacted on a 1.0% y-o-y decline in total final consumption in H1 2014. Broken down by quarter, final consumption receded in Q1, but stagnated in Q2 owing to moderate recovery of household consumption. Following a decline in Q1 (0.5% s-a), domestic demand picked up in Q2 (0.4% s-a), as suggested by retail trade volumes (its most important indicator) and rising real wage bill in Q2.

In contrast, government final consumption, under the strongest impact of fiscal consolidation, contracted in both quarters (0.4% s-a in Q1 and 0.8% s-a in Q2), as confirmed by movements in unit labour costs in the public sector and expenditure for the purchase of goods and services.

Fixed investment fell by 5.7% y-o-y in H1, due entirely to private sector investment. At the same time, government investment stepped up. An 8.9% decline in private investment in H1 (contribution to aggregate demand: -1.5 pp) is evidenced by reduced imports of equipment, production of domestic machinery and equipment, and a lower number of issued construction permits. Government investment increased by 25.6% y-o-y in H1, adding 0.5 pp to aggregate demand. The growth is confirmed by consolidated capital budget expenditure which, following a vigorous fall in 2013, hit an upward trajectory since the start of 2014.

A reduction in current assets investment (change in inventories) adversely affected aggregate demand with 1.4 pp. A drop in inventories was recorded for capital goods, energy and durable consumer goods. Based on exports of the main agricultural commodities (wheat and corn), we estimate that inventories of agricultural commodities decreased as well.

Net external demand

In the course of H1, exports continued to grow faster than imports in y-o-y terms, lending a boost to aggregate demand. However, growth in real exports (11.5% y-o-y) decelerated further, particularly in Q2, partly due to the floods that constrained the manufacturing activity. Besides, the floods affected a rise in real imports of goods and services (3.0% y-o-y) through higher imports of energy products, thus further diminishing the positive contribution of net exports.

Euro-denominated commodity exports rose by 11.6% y-o-y in H1 and were led mainly by exports of agricultural products and the automobile industry. Following a solid agricultural season, wheat exports in the July 2013–June 2014 period reached their historical high of 1.1 mln tonnes, whereas corn exports amounted to around 1 mln tonnes in H1, which is close to the multi-annual average. Furthermore, "Fiat Automobiles Serbia" remained the largest individual exporter in H1, recording exports worth close to EUR 800 mln. In addition, a strong impetus to growth in exports originated from exports of petroleum products, electrical equipment and food.

Euro-denominated commodity imports went up by 2.4% y-o-y in H1. Broken down by component, imports of production inputs and consumer goods edged down, whilst imports of unclassified goods went up. Diminishing imports of consumer goods are corroborated by a robust decline in the value of imported computers, electrical equipment and food. In regard to intermediate goods, imports of chemical products were on a steep decline. Conversely, the sharpest increase in H1 imports was noted for petroleum products and motor vehicle parts.

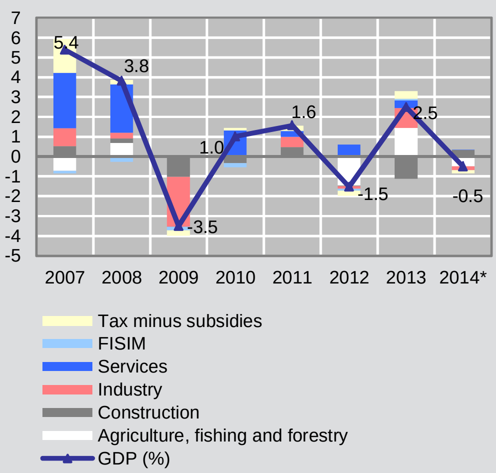
7. Economic activity

After experiencing relatively favourable economic developments in the first four months of the current year, Serbia was hit by floods in May, leaving serious consequences on agricultural and industrial production. GDP fell by 0.5% y-o-y in H1, slipping in June 2.3% below its pre-crisis figure. NAVA lost 0.1% y-o-y and also slid 2.3% below the pre-crisis level.

Measured by GDP, economic activity stagnated in Q1 (a 0.1% rise y-o-y or -0.4% s-a). A positive contribution was provided by construction, while the downturn in agriculture and industrial sectors exerted a negative impact. The May floods brought about a 1.1% decline in GDP in Q2 both q-o-q and y-o-y.

As the May floods affected the most the sectors of agriculture, mining and electricity, gas and steam supply, these three sectors gave the strongest contribution to the decline in GDP in H1. The largest damage within agriculture was observed in fruit growing, cattle breeding and farming. What is more, a large portion of production is concentrated in the most heavily stricken areas – Western Serbia and Pomoravlje. Agricultural production is estimated to have receded by 4.6% y-o-y in H1, adding negative 0.3 pp to GDP.

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



Sources: SORS and NBS calculation.
* NBS estimate.

However, since Vojvodina as the main agricultural region did not suffer much flooding, the losses in agriculture are comparatively smaller.

In H1, the sector of electricity, gas and steam supply dropped by 6.2% y-o-y, and mining lost 6.3% y-o-y (contributions to GDP of -0.2 pp and -0.1 pp respectively). The heaviest damage was inflicted on the

Table III.7.1 **Economic activity in H1 2014**

	Growth rates (%)	Contribution to GDP growth (pp)
Gross domestic product (GDP)	**-0.5**	**-0.5**
Agriculture, forestry and fishing	-4.6	-0.3
Mining and quarrying	-6.3	-0.1
Manufacturing	0.0	0.0
Electricity, gas, steam and air conditioning supply	-6.2	-0.2
Water supply; sewerage, waste management and remediation act.	0.1	0.0
Construction	-4.7	-0.1
Wholesale and retail trade; repair of motor vehicles and trailers	-2.0	-0.2
Transportation and storage	3.6	0.2
Accommodation and food service activities	-5.0	0.0
Information and communications	5.8	0.3
Financial and insurance activities	-2.5	-0.1
Real estate activities	12	0.1
Professional, scientific and technical activities	-12	0.0
Administrative and support service activities	6.0	0.1
Public administration and defence; compulsory social security	-0.6	0.0
Education	0.4	0.0
Human health and social work activities	-0.3	0.0
Arts, entertainment and recreation	-3.3	0.0
Other service activities	-3.5	0.0
Activities of households as employers; services-producing act. for own use	-4.1	0.0
Gross value added by activities	-0.6	-0.5
FISIM	3.5	0.1
Gross value added (GVA)	-0.5	-0.4
Taxes on products minus subsidies on products	-0.1	0.0

Sources: SORS and NBS calculation.

main coalmines in the Kolubara basin which were flooded to the brim and which account for around 50% of electricity generation in Serbia.

Up to April, manufacturing recorded positive developments[29] and was driven by elevated production in automobile, oil and food industries. However, manufacturing trended down in May and June because of the constrained use of production capacities during the extraordinary situation and reduced electricity supply. As a result, manufacturing stagnated in H1. Broken down by field, the largest increase in the physical volume of production was seen in the production of motor vehicles, pharmaceutical products and preparations, and rubber and plastic products. In contrast, the production of metal products, machines and equipment, and computers, recorded a smaller physical volume.

Construction is estimated to have contracted by 4.7% y-o-y in H1, adding negative 0.1 pp to GDP. However, as flood restoration works will bolster construction in H2, a positive contribution of this sector is expected by the year-end.

Within services, a H1 rise was observed for information and communications (5.8% y-o-y, contribution of 0.3 pp) and transport and storage (3.6% y-o-y, contribution of 0.2 pp), whereas trade was on a decline (2.0% y-o-y, contribution of 0.2 pp). Fiscal consolidation measures adopted last year dragged down the majority of government-related sectors.

In H2, economic activity is estimated to record movements similar to those in H1. At the level of 2014, GDP is expected to decline by 0.5% y-o-y. An impetus is likely to come from construction and the sector of services, whilst agriculture and industrial production will probably decline.

8. Wages and employment

Nominal net wages stagnated from the start of 2014, which, along with positive inflation, triggered their fall in real terms. At the same time, a larger decline was observed in the public (3.0% s-a) than private sector (2.2% s-a). Y-o-y, real net wages declined slightly in the private sector (0.3%), but stagnated in the public sector (0.1%).

All sectors, apart from information and communications, saw a reduction in real wages in H1. The heftiest fall was recorded in financial services, agriculture, professional, innovation and technical activities, and mining.

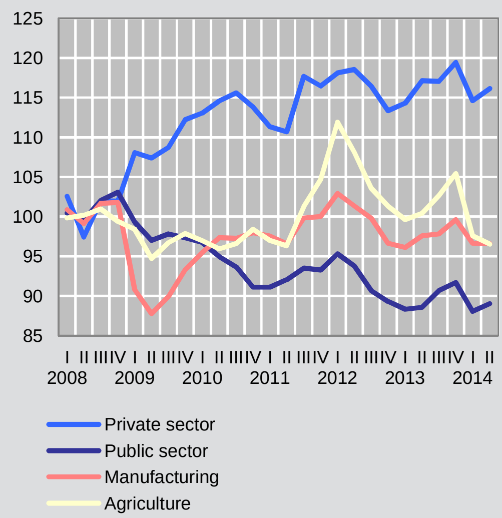
In H1, the average paid nominal net wage amounted to RSD 43,398 in the private sector, and was lower compared to the average public sector wage (RSD 48,845).

Unit labour costs of the total industry remained broadly unchanged in H1 since a 2.4% y-o-y rise in real gross wages neutralised the productivity growth of 2.8% y-o-y. More favourable developments were noted in manufacturing, where productivity growth (5.5% y-o-y) exceeded the rise in real gross wages (2.9% y-o-y) and pushed down unit labour costs by 2.7% y-o-y.

Circumstances in the labour market improved somewhat in H1. The number of active persons in the labour market increased – measured by the participation rate, it equalled 62.5% in June. The employment rate picked up by 0.3 pp to 39.5%, and the unemployment rate to 20.3%. In the same period, the share of informally employed in total employment increased to 21.2%.

Employment grew in the majority of catering sectors, particularly activities of households as employers. A

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



Sources: SORS and NBS calculation.

[29] Growth of 2.4% in the January–April period.

somewhat smaller rise was recorded for the sectors of trade, information and communications, and transport. Due to seasonal factors, agriculture and construction witnessed the largest cuts in employment numbers. A significant drop in employed persons was also seen in manufacturing. Employment went up in the sectors of electricity, gas and steam supply, and mining.

The entire increase in H1 employment pertained to persons working full-time, whereas the number of part-time workers declined. Unemployment among the young (15–24 years of age) continued up, reaching 52.8%. On the other hand, the share of those seeking a job for over a year decreased by 7.1 pp to 69.7%. In category terms, the number of persons employed with legal entities and family workers increased, while the number of self-employed persons went down.

According to the Serbian Statistical Office, formal employment fell by 13,931 in H1, most notably in the private than public sector. The sharpest cuts were made in manufacturing and construction. In the public sector, employment declined in healthcare and public administration. It was only in the sectors of information and communications, and administrative and support service activities that employment went up in H1.

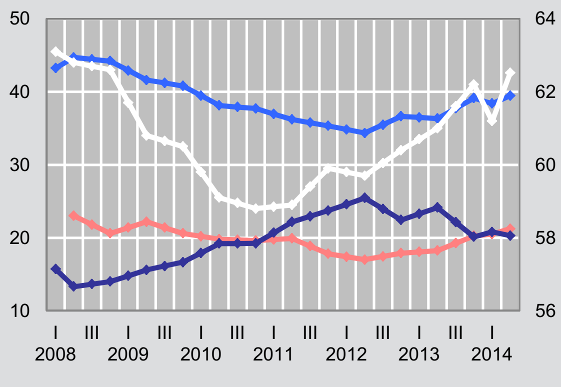
As suggested by data of the National Employment Service, the unemployment figure was up by 3,823 in H1. The increase related entirely to earlier employed persons, while the number of first-time job seekers went down. In the January–May period, the number of unemployment beneficiaries fell by 2,512 to 61,070 in May, which implies the lowest level since early 2012.

9. Inflation expectations

Low inflation in H1 and low expected inflationary pressures stabilised inflation expectations of financial and corporate sectors within the target tolerance band. Their expectations levelled off both in the short and medium run, which diminishes the costs of achieving price stability in the coming period.

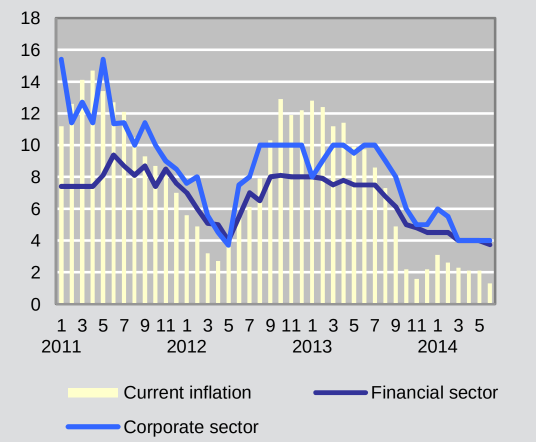
According to the Bloomberg agency, one-year ahead inflation expectations of the financial sector, which returned within the target tolerance band in October last year, fell in January to the target level (4.0%). They temporarily moved up over the next two months (4.6% and 5.0% respectively), only to stabilise at 4.5% by the end of the period observed.

Chart III.8.2. **Rates of activity, formal and informal employment under the Labour Force Survey**



Source: SORS.

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



Sources: Gallup, Ipsos and NBS.
* Ipsos from November 2011 and Gallup in the earlier period.

As indicated by the Ipsos survey, financial sector expectations slid from 4.5% in the first two months of 2014 to the target level in March. They stayed there up to June, when they dropped to 3.8%. From November last year, corporate expectations trended within the target band, apart from January when they picked up to 6.0%. They dipped to 5.5% in February, reaching the target in March, where they remained over the next three months.

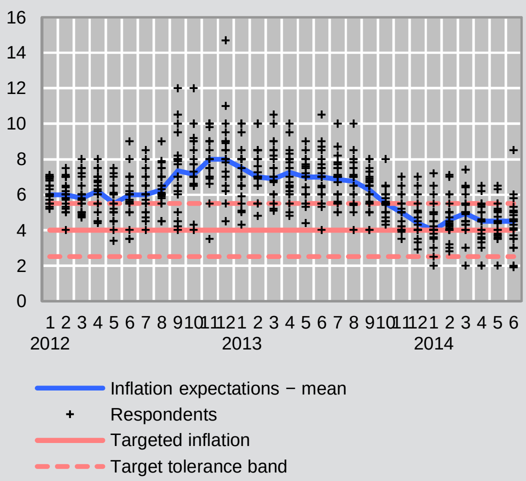
One-year ahead inflation expectations went up only in the household sector. However, although household expectations invariably outstrip those of financial and corporate sectors, these two sectors being better informed of macroeconomic developments, a change in the methodology of the household survey should also be borne in mind. Up to the March survey, respondents expressed their expectations only after being presented with data on current inflation. As of March, such information is not given to households, which is the principal reason why their expectations touched 8.0% and 10.0% in March and April respectively, vs. 5.0% in February. Households are now required to specify the inflation rate that they believe to have been achieved over the previous year (perceived inflation). As such inflation rate, much higher than actual, is above or equal to the rate expected by households for the next year, movements in household inflation expectations can also be assessed positively.

Table III.9.1 **Households' inflation expectations and perception**
(y-o-y rates, %)

		Perceived inflation in previous year	One-year ahead expected inflation	Two-year ahead expected inflation
2014	March	10.0	8.0	8.0
	April	10.0	10.0	8.0
	May	10.0	10.0	10.0
	June	15.0	10.0	10.0

Source: Ipsos.

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



Sources: Bloomberg and NBS.

Medium-term inflation expectations – for two years ahead, have been within the target tolerance band since March when this question was introduced, and stayed unchanged up to June, both in financial and corporate sectors. The financial sector pared back its expectations in June, from 4.5% to 4.0%, while corporates lifted them up from 4.0% to 5.0%. In March and April, households expected two-year ahead inflation to reach 8.0%, or 10.0% as of May.

Following low levels recorded since end-2013, the dispersion of responses widened across sectors in H1. Greater disagreement is probably due to uncertainties as to the flood effects on inflation.

10. Fiscal policy

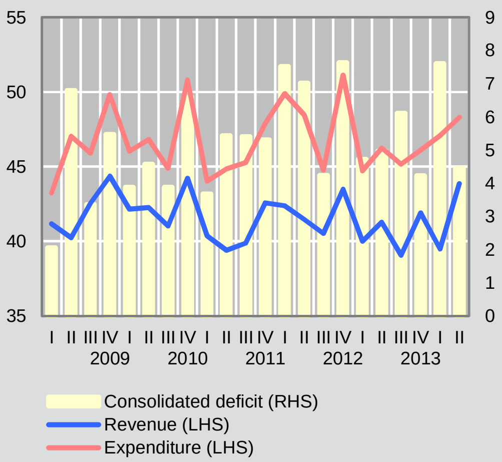
Budget revenue in H1 underperformed the levels envisaged by the Budget Law, which is partly due to the fact that the macroeconomic performance deviated from the projection (lower GDP and inflation, as well as weaker depreciation of the dinar against the euro). On the other hand, as budget expenditure was consistent with the projection, the consolidated budget deficit reached RSD 103.8 bln (6.0% of GDP) already in H1, or around 75% of the deficit planned for the entire 2014.

The floods will also exert a negative impact on fiscal developments this year. The budget deficit is estimated to widen by around 1.0 pp on account of the floods. The economic contraction, notably in energy and mining fields, will drag down budget revenue, whereas the allocation of additional funds for urgent restoration of flood damages will prop up budget expenditure. Furthermore, the floods delayed the adoption of the budget revision, which was initially planned for end-June. However, in the meantime a set of laws was adopted, aimed at supporting the sweeping structural reforms[30].

The consolidated budget deficit was fully determined by the central government deficit which equalled RSD 117.6 bln in H1, or 63.8% of the level envisaged by the Budget Law. Unlike the Republic, other government sectors posted budget surpluses in H1 – the local self-government: RSD 7.3 bln, autonomous province of Vojvodina: RSD 4.1 bln, and the National Health Insurance Fund: RSD 10.0 bln.

In H1, consolidated budget revenue amounted to RSD 721.7 bln in H1, up by 1.9% y-o-y in real terms. Tax receipts rose mostly on account of a higher profit tax (50.4% in real y-o-y terms), which was due to the economic upturn in 2013 and an increase in the tax rate from 10% to 15%. Social security contributions also went up, while income taxes declined, which may be associated with legislative changes in 2013.[31] VAT receipts stayed broadly unchanged in H1 relative to the same period last year, despite an increase in the special rate from 8% to 10% in January. Excise receipts dropped by 0.4% in real y-o-y terms, whereas the collection of excise duties on petroleum products increased significantly after the labelling of fuel. At the same time, the collection of excise duties on tobacco remained on a downturn as unregistered trading in tobacco stepped up.

Chart III.10.1 **Consolidated revenue, expenditure and deficit**
(% of GDP)



Sources: Ministry of Finance and NBS.

In H1, consolidated budget expenditure rose by 4.1% in real y-o-y terms, chiefly on account of rising interest payment expenses (35.1% y-o-y) and capital expenditure (24.0% y-o-y). In addition, weaker real growth was also recorded for outlays for the purchase of goods and services and subsidies, which was partly due to the settlement of government obligations of the previous year. On the other hand, employee expenses fell by real 1.4% y-o-y, owing to better controls following the introduction of a centralised employee registry, bans on public sector employment and caps on the number of temporarily engaged persons. Social transfer costs remained unchanged y-o-y. In addition, pension outlays increased and unemployment benefits went down.

In H1, the bulk of funds for budget deficit financing and the repayment of due liabilities was obtained through borrowing in the domestic market. Dinar securities were issued in the amount of RSD 260.7 bln, which, with the performance ratio of 84.2%, resulted in the sale of securities worth RSD 219.6 bln. In the same period, securities worth RSD 157.6 bln fell due. Furthermore, the government borrowed by selling euro-denominated securities of EUR 647.6 mln (of total EUR 838.6 mln issued), whereas securities worth EUR 356.9 mln fell due.

As there were no sales in eurobonds in the international financial market in H1, the stock of debt, due to coupon payment, fell by EUR 40.5 mln to EUR 3.8 bln in June.

Total government public debt increased by EUR 518.9 mln in H1 to EUR 20.7 bln in late June. The public debt to GDP ratio was up by 1.8 pp to 65.6% in June.[32] In the same period, the currency structure of public debt changed as the dinar portion increased and the FX portion narrowed. From the viewpoint of public debt sustainability, this change may be assessed as positive. The share of dinar in total public debt increased in H1 by 2.0 pp to 22.3% in June.

[30]Amendments to laws on labour, pension-disability insurance, bankruptcy and privatisation.

[31] Amendments to the Law on Personal Income Tax envisage a cut in the wage tax rate from 12% to 10%. According to amendments to the Law on Mandatory Social Insurance, the contribution rate for pension and disability insurance increased from 22% to 24%. These changes came into effect on 30 May 2013.

[32] In monitoring the share of public debt in GDP by quarter, the NBS applies standard international practice and observes public debt in relation to GDP, estimated to have been recorded over the last four quarters. According to data of the Ministry of Finance, the public debt to estimated GDP ratio equalled 63.0% in late June. The difference lies in different assessment of nominal GDP.

Index of charts and tables

Charts

Tables

CIP - Katalogizacija u publikaciji
Narodna biblioteka Srbije, Beograd

336.7

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

Два пута годишње. - Varijantni naslov: Semi-annual
Monetary Policy Report. - Ima izdanje na
drugom jeziku: Godišnji izveštaj o
monetarnoj politici (Narodna banka Srbije) * =
ISSN 2217-6292
ISSN 2217-6535 = Annual Monetary Policy
Report (National Bank of Serbia)
COBISS.SR-ID 185843468