National Bank of Serbia

2015

January-June

SEMI-ANNUAL

MONETARY POLICY REPORT

2015

January–June

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MONETARY POLICY REPORT

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Introductory note

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

Pursuant to the 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, 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 2015 was adopted by the NBS Executive Board at its meeting of 10 September 2015.

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

Executive Board of the National Bank of Serbia:

Jorgovanka Tabaković, Governor

Ana Gligorijević, Vice Governor

Veselin Pješčić, Vice Governor

Diana Dragutinović, Vice Governor

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

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

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

ABBREVIATIONS

bln – billion
bp – basis point
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
GDP – Gross Domestic Product
H – half-year
IFEM – Interbank Foreign Exchange Market
IFI – international financial institution
IMF – International Monetary Fund
mln – million
NAVA – non-agricultural value added
NPL – non-performing loan
OFOs – other financial organisations
Q – quarter
q-o-q – quarter-on-quarter
s-a – seasonally-adjusted
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

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Overview

Inflationary pressures stayed rather low in the first six months of the year, reflecting weak cost-push pressures on account of falling international primary commodity prices (oil and primary agricultural commodities) and low inflation abroad. On the demand side, disinflationary pressures stemmed largely from tight fiscal policy and weak lending activity. Year-on-year inflation continued to move below the lower bound of the target tolerance band (4.0±1.5%) mainly as a result of factors with a temporary effect – absence of the expected administered price adjustment and the drop in petroleum product prices trigerred by the collapse of oil prices in the global market. In June 2015, inflation measured 1.9% year-on-year.

Consistent implementation of fiscal consolidation measures and conclusion of a stand-by arrangement with the International Monetary Fund opened up the scope for further monetary easing. Still, because of unfavourable movements in the international environment early in the year, the key policy rate was kept unchanged in January and February, but was cut in the next four months by 200 basis points in total – from 8.0% to 6.0%. These cuts fed through into lower interest rates in the interbank money market and the credit market. As regards other measures, monetary authorities lowered the FX reserve requirement ratios again (by 1 percentage point) in order to provide additional impetus to credit activity, and narrowed the interest rate corridor from ±2.5 percentage points to ±2.0 percentage points relative to the key policy rate in order to ensure further stabilisation of interest rates in the interbank money market.

The macroeconomic environment in which monetary policy was implemented in the first half of 2015 was more favourable than in the previous year, owing primarily to improved macroeconomic prospects of the country, notably better balance of payments and fiscal performance. At the same time, numerous challenges continued stemming from the international environment.

Early in the year, international financial markets experienced a bout of volatility amid decreasing predictability of the monetary policy moves of leading central banks, the collapse of global oil prices and geopolitical tensions. The markets calmed down and global liquidity picked up following the European Central Bank's decision to start the purchase of sovereign securities in March and the Federal Reserve System's deferral of rate hikes for the second half of the year. The economic recovery of the euro area steadily gathered pace, creating positive ripple effects in the region of Central and East Europe.

The recovery of the euro area also had a positive effect on activity in the domestic manufacturing industry. As a result of this and the recovery of mining and energy production capacities from flood damage as well as the positive trends in construction industry, in the second quarter, Serbia's gross domestic product recorded year-on-year growth (1.0%), for the first time after four quarters. At the same time, most of the service sectors registered a decline. Agricultural production is also estimated to have contracted relative to the previous year due to drought. In the remainder of the year, we expect to see positive trends continuing in industry and construction, which, together with the recovery of some service sectors should lead to accelerated growth in gross domestic product. According to our estimates, this growth should amount to around 0.5% in 2015.

On the expenditure side, positive contribution to movements in gross domestic product in the first half of the year originated from private investment, while household and government consumption and government investment worked in the opposite direction. Private investment is expected to continue up in the remaining part of the year, which, together with the healing of net external demand – prompted by faster recovery of Serbia's key trade partners and accelerated execution of capital projects, should contribute to the growth in gross domestic product.

Though net exports failed to give a positive contribution to economic activity in the first six months, primarily because of increased imports of equipment, external imbalances continued narrowing down. The current account deficit amounted to EUR 728.0 million or 4.7% of gross domestic product in the period observed, and was by around 30% lower than in the same period a year earlier. This is largely attributable to the increase in the surplus on trade in services and the surplus on the secondary income account, but also to a decrease in the deficit on the primary income account, while the deficit on trade in goods edged up slightly. In contrast to the same period of the previous year, the capital and financial account recorded a net capital inflow. Favourable balance of payments developments fed through into higher foreign exchange reserves of the National Bank of Serbia which reached EUR 10.3 billion at end-June, covering close to seven months' worth of imports of goods and services.

The first half of the year saw not only a reduction in external, but also in internal imbalances. Consolidated budget deficit amounted to RSD 35.3 billion or 1.9% of gross domestic product and was almost 70% lower than in the matching period of 2014. Interest payments excluded, Serbia recorded a primary budget surplus equivalent to 2.0% of gross domestic product. Propelled by measures aimed at fighting the grey economy and higher non-tax revenue, consolidated budget revenue rose by 5.1% year-on-year in real terms in the first half of the year. On the other hand, fiscal consolidation measures adopted last year bore down on consolidated expenditure which declined by 4.6% year-on-year in real terms.

End-of-period, the dinar strengthened aginst the euro in the first half of the year by 0.3%. In terms of averages, the dinar weakened against the euro by 1.8% relative to the second half of the previous year. Depreciation pressures prevailed in January, chiefly under the impact of increased demand of domestic enterprises for foreign exchange and reduced investment in government securities amid volatility in the international financial market. In February and March, the dinar perked up as a result of more favourable risk perception following the conclusion of a stand-by arrangement with the International Monetary Fund and increased liquidity in the international financial market after the European Central Bank's measures. In the rest of the period observed, movements in the foreign exchange market were relatively stable owing to improved macroeconomic and fiscal prospects, affirmation of the country's credit rating by Fitch and Standard&Poor's and buoyed inflow of remittances and foreign investment in equity. To ease excessive short-term volatility of the exchange rate in the first half of the year, the National Bank of Serbia intervened in the Interbank Foreign Exchange Market by buying EUR 410.0 million and selling EUR 120.0 million.

Progress in the implementation of policies agreed under the programme with the International Monetary Fund is reviewed on a quarterly basis. As all quantitative criteria have been met so far, we expect that the second review will result in a positive assessment. The National Bank of Serbia, on its part, will continue to take all measures and carry out activities to deliver on its committments under the programme. Ensuring low medium-term inflation and maintaining stability of the financial system remain its principal objectives, this being the best way for the central bank to contribute to the country's economic prosperity.

Maintaining price stability is to some degre facilitated by the well-anchored inflation expectations which, in the first six months of the year, continued to move around the mid-point of the medium-term inflation target. Additional support will come from continued consistent implementation of fiscal consolidation measures and structural reforms. Coupled with the arrangement with the International Monetary Fund, this should contribute to the sustainability of public finances and further improvement of the country's macroeconomic prospects. As external risks persist, future monetary policy stance will depend on the assessment of their impact on inflation, as well as on the effects of this year's agricultural season on primary agricultural commodity prices in the domestic and international markets.

I. Strategic monetary policy framework

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

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

The inflation target of the NBS is defined in terms of the headline inflation rate (with a tolerance band) measured as the annual percentage change in the Consumer Price Index (CPI). To define the framework for medium-term monetary policy decision-making and to anchor and stabilise inflation expectations, in August 2015 the NBS Executive Board set the inflation target for the period January 2017–December 2018 at 4.0%±1.5 pp.[2] The inflation target determined earlier for 2016 (also 4.0%±1.5 pp) has been kept unchanged.[3]

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 2018 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 requires monetary policy changes that could cause additional disruptions to macroeconomic processes. This relates to shocks in primary commodity prices or deviations from the planned growth in prices under direct or indirect government regulation. In cooperation with the Government, the National Bank of Serbia may change the targets set for inflation. Such changes will be made in exceptional circumstances only and will be explained by the National Bank of Serbia.

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

[2] The National Bank of Serbia's Memorandum on Inflation Targets until 2018, adopted by the Executive Board at its meeting of 13 August 2015. See Appendix 1, p. 34.

[3] See the National Bank of Serbia's Memorandum on Inflation Targets until 2016 on the NBS website (http://www.nbs.rs).

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

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

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

II. Monetary policy and achievement of the inflation target

1. Monetary policy in the period January–June 2015

Monetary policy easing continued in H1 2015 – the key policy rate was cut from 8.0% to 6.0%. Additional room for monetary easing is owed primarily to consistent implementation of fiscal consolidation measures and the conclusion of a precautionary arrangement with the IMF.

After falling to a minimum level in January, y-o-y inflation followed an upward path, staying however below the lower bound of the target tolerance band during the period observed. The undershooting of the target tolerance band is largely attributable to the absence of expected administered price adjustment and the fall in petroleum product prices driven by the collapse of oil prices in the global market. A gradual rise in consumer prices was expected on the back of administered price adjustment and gradual waning of the disinflationary effect of low primary commodity prices. On the other hand, it was expected that the majority of domestic factors and low inflation in the international environment would slow down the rise in prices, which had a decisive impact on the Executive Board's decision to trim the key policy rate during the review period.

In making the decision to ease monetary policy, the Executive Board of the NBS also took into account that disinflationary pressures were reinforced by tightened fiscal policy, which confirms the commitment of the Serbian economic policy makers to strengthen public finances. Along with structural reforms and the conclusion of the arrangement with the IMF, all of the above positively impacted the country’s risk premium and investors’ perception of the risk of investing in Serbia.

Fiscal adjustment was crucial for the maintenance of the country's macroeconomic stability, given uncertainties in the international environment over several key issues: the rate of global economic recovery, effects of divergent monetary policies, unexpected moves of leading central banks, movements in world oil prices and ongoing geopolitical tensions.

When cutting the key policy rate, the Executive Board also expected the market to react accordingly, i.e. that dinar interest rates in the money and credit markets would be reduced further, as eventually they did. This reduction should facilitate economic recovery in the foreseeable future.

The stable movement of inflation expectations within the target tolerance band indicated that there were no major inflationary pressures. Owing to an extended period of low inflation and anticipation of weak inflationary pressures in the period ahead, short- and medium-term inflation expectations stabilised, which is the key prerequisite for the stabilisation of inflation and greater efficiency of monetary policy measures.

In monthly terms, after remaining unchanged in January and February, the key policy rate was cut in March.

In spite of low inflationary pressures, **the key policy rate was not changed in the first two months of H1**. This decision of the Executive Board was guided primarily by continuing unfavourable movements in the international environment. The collapse of global oil prices in late 2014 and early 2015 and the geopolitical events, as well as the diminished predictability of monetary policies of leading central banks increased uncertainties in the international financial market. An additional blow to this market came in January from the unexpected move of the Swiss National Bank which removed the 1.20 cap on the Swiss franc against the euro. These circumstances prompted investors to re-examine their risk perception of emerging market economies and increased Serbia's risk premium in early January. However, the affirmation of Serbia's credit rating by Fitch and Standard & Poor's owing to the adoption of fiscal consolidation measures, the implementation of structural reforms and the conclusion of the precautionary agreement with the IMF, helped reverse the risk premium trend and contributed to its lower level in the remainder of H1. Along with low inflationary pressures reflecting developments in the majority of domestic factors and low inflation in the international environment, this was the main reason behind the decision of the Executive Board to **cut the key policy rate in the remaining four months of the period under review**.

Also, trends in the international environment turned more favourable than in early H1 as global liquidity started increasing again. In fact, in addition to the already implemented accommodative measures, the ECB embarked in March on a programme of purchasing government securities of member states in order to encourage economic activity. At the time, the Fed did not change its policy rate, although it hinted that it would start doing so in the coming period. Considering the low, even negative yields in advanced economies, high global liquidity and climbing investor demand for higher yields were expected to make a positive contribution to capital inflows to Serbia and the stability of the FX market.

Towards the end of H1, the international financial market was shaken by the breakdown of negotiations to resolve the Greek crisis and the possibility of grexit. While the direct effects caused by the escalation of this crisis would have been small, the Executive Board took into account the risk of potential indirect effects through the impact of the Greek crisis on the euro area recovery and/or the international financial market. Although the agreement between Greece and its European creditors has been reached, the further development of the Greek situation and its effects, primarily on euro area recovery, is still a source of instability in the international environment. This is compounded by the uncertainty over global prices of primary commodities, notably the price of oil, as well as the effects of anticipated asymmetric exit of leading central banks from accommodative monetary policies. For these reasons, the NBS will continue to cautiously monitor trends in the international environment and seek to mitigate the spillover of negative consequences to the Serbian market.

2. Monetary policy instruments

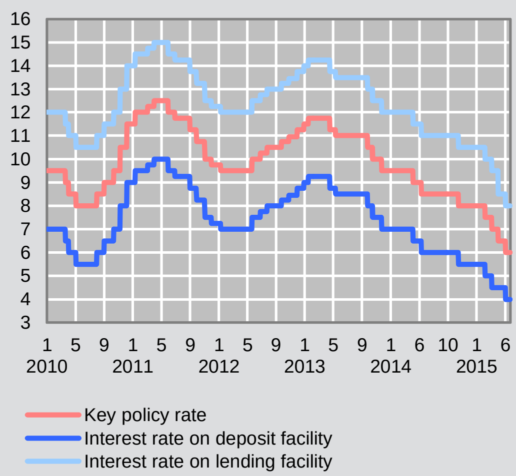
The main monetary policy instrument of the NBS is the key policy rate, i.e.interest rate used by the NBS to conduct the main open market operations. The role of the key policy rate is supported by the corridor of interest rates on deposit and lending facilities and by other open market operations. In 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).

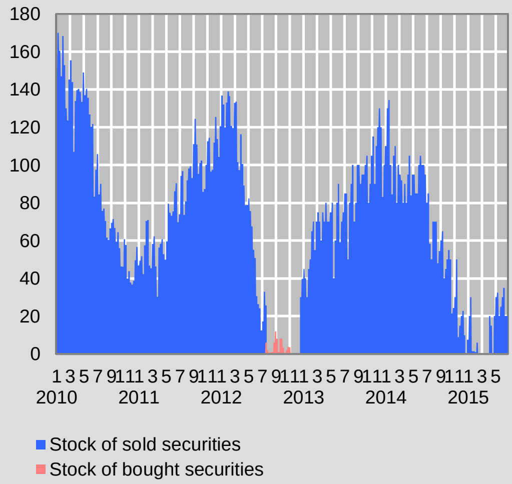
The NBS implemented reverse repo transactions by selling own securities. For these purposes, in 2015 the NBS issued one series of bills in the nominal amount of RSD 500.0 bln. The issuing of one series of high nominal value is consistent with the practice in earlier years which enables a more adequate management of securities

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.

within the same series and facilitates liquidity management for banks.

There were 18 repo sale auctions in H1 2015. They were organised once a week and the securities were offered at the variable multiple interest rate. The sales totalled RSD 327.6 bln, significantly less than in H2 2014 (RSD 1,161.3 bln).

The stock of NBS bills in banks' portfolio averaged RSD 12.8 bln in H1. Relative to end-2014, the stock of these bills increased by RSD 12.5 bln, to RSD 20.0 bln in late June. The increase reflected chiefly the increase in dinar liquidity caused by the National Bank's purchases of foreign currency in the IFEM

Deposit and lending facilities

In accordance with the Decision on Terms and Conditions of Depositing Excess Liquidity with the National Bank of Serbia, banks continued to place their excess liquidity in overnight accounts with the central bank. The average daily stock of bank deposits with the NBS in H1 2015 came at RSD 32.5 bln, which is RSD 23.6 bln more than in H2 2014. Broken down by month, the highest average stock was recorded in May (RSD 51.1 bln) and the lowest in February (RSD 10.2 bln).

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

During the review period, banks used intraday and overnight loans. Intraday loans amounted to a total of RSD 14.1 bln, three quarters of which were disbursed in March. Banks drew overnight loans in the total amount of RSD 15.2 bln, of which the largest amounts were disbursed in March (RSD 11.0 bln), February (RSD 2.2 bln) and June (2.0 bln).

To reduce the possibility of sharp fluctuations of interest rates in the interbank money market, in May 2015 the NBS amended the Decision on Interest Rates Applied by the National Bank of Serbia in the Implementation of Monetary Policy. Under this Decision, the NBS charges interest to commercial banks on the amount of overnight liquidity loans against the collateral of securities at the rate which is equal to the key policy rate plus 2 percentage points, while paying interest to banks on the amount of funds deposited with the NBS at the rate which is equal to the key policy rate minus 2 percentage points.

In this way, the NBS narrowed the interest rate corridor from ± 2.5 pp to ± 2.0 pp relative to the key policy rate in order to further stabilise interest rates in the interbank money market.

Required reserves

The Decision on Banks' Required Reserves with the National Bank of Serbia was amended once in the course of H1.

At its January meeting, the NBS Executive Board lowered the FX reserve requirement ratio from 27% to 26% on sources of funding with the maturity of up to two years and from 20% to 19% on sources of funding with the maturity of over two years, while raising the dinar share of FX required reserve allocations from 36% and 28% to 38% and 30%, depending on the maturity of liabilities. Through this measure the NBS continued the relaxation of FX reserve requirements initiated in November 2014 in order to stimulate bank lending in a low inflation environment by lowering the cost of funding for banks and unlocking a part of their credit potential.

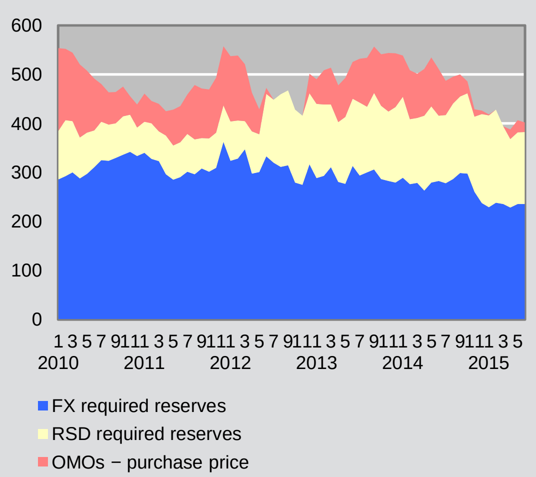
The amount of required reserves held in dinars rose by RSD 5.3 bln in H1, coming at RSD 163.5 bln in June. This rise was propelled primarily by the said January changes in regulations and higher FX required reserve base, but was however partly cushioned by the effect of the dinar's strengthening against the euro. The increase in required reserve allocations in dinars was also triggered by the rise in dinar household deposits with banks. The required reserve allocations in foreign currency declined by EUR 56.9 mln in H1, coming at EUR 1,944.9 mln in June, primarily as a consequence of the said January change in regulations.

The structure of foreign currency reserving base shows that, starting from the February maintenance period, the share of foreign liabilities increased mainly due to the annulment of the provision of the decision exempting foreign liabilities of banks from the reserving base. The increase in the reserving base also came from higher household FX savings and corporate deposits.

Foreign exchange market operations

Under the 2015 Monetary Policy Programme, the NBS continued implementing the managed floating exchange rate regime. Its interventions in the foreign exchange

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



Source: NBS.

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

In nominal terms, the dinar strengthened against the euro by 0.3% in H1. The NBS intervened in the interbank foreign exchange market as a net buyer of EUR 290.0 mln, purchasing EUR 410.0 mln and selling EUR 120.0 mln. The NBS intervened as a price taker, strictly under market conditions.

In Q1, the dinar appreciated vis-à-vis the euro by 0.6%. Depreciation pressures felt early in the year were primarily a consequence of higher FX demand of domestic energy importers. However, positive expectations of market participants regarding the signing of the precautionary stand-by arrangement with the IMF, that would serve as a guarantee of further implementation of fiscal consolidation measures and structural reforms, sparked investors' interest in longer maturity government securities. Hence a change in the dinar's path and its strengthening against the euro in February and March. Also, February saw lower FX demand of domestic enterprises, while non-residents showed keen interest to invest in government securities in March as well, owing to positive initial results of fiscal consolidation (lower than anticipated budget deficit), and the start of implementation of ECB' quantitative easing programme.

During Q1, the NBS intervened by purchasing EUR 260.0 mln and selling EUR 90.0 mln.

The dinar weakened against the euro by 0.3% in Q2. Its relative stability was propped up by Serbia's improved macroeconomic and fiscal prospects. Against the backdrop of reduced external trade imbalances, net purchase of foreign exchange by residents was lower than usual. At the same time, banks bought a higher amount of foreign cash from exchange dealers and natural persons.

Banks served as an additional buttress to the stability of domestic FX market, by selling foreign exchange in the interbank FX market amid granting of FX-indexed loans to domestic enterprises. Further contribution came from the reduction in FX-indexed deposits[4].

In Q2, the NBS intervened by purchasing EUR 150.0 mln and selling EUR 30.0 mln.

[4] When FX-indexed assets are increased or FX-indexed liabilities are reduced, a bank has a long FX position, and in order to balance its FX position and reduce the exposure to foreign exchange risk, the bank sells foreign exchange in the FX market. The opposite is required when FX-indexed assets are reduced and FX liabilities increased. The bank then needs to purchase foreign exchange in the market.

Foreign exchange swaps

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

In H1, the NBS held 50 three-month and 46 two-week FX swap auctions, buying/selling EUR 29.0 mln and EUR 170.5 mln, respectively. At the end of H1, NBS receivables and liabilities under three-month swaps equalled EUR 14.0 mln each, while those under two-week swaps equalled EUR 5.0 mln each.

3. Achievement of inflation target in the period January–June 2015

Inflationary pressures remained muted in H1 as well, reflecting the majority of domestic factors, low prices of primary commodities in the world market and subdued inflation in the international environment.

Y-o-y inflation continued to move below the lower bound of the target tolerance band (4±1.5%) primarily on account of temporary factors – the absence of the expected administered price adjustment and a fall in petroleum product prices, driven by a collapse of global oil prices. Due to the high base caused by rising VAT and excise rates early last year, y-o-y inflation hit a trough in January (0.1%). It picked up thereafter, mirroring the seasonal growth in fruit and vegetable prices in February and March, and ended H1 at 1.9%.

Besides fruit and vegetable prices, a positive impetus to y-o-y inflation in H1 came from prices of non-food products and services. Petroleum product prices (driven by tumbling global oil prices) and administered prices worked in the opposite direction. For the first time on record, administered prices fell in y-o-y terms – by 1.5% in June (contribution to y-o-y inflation equalling -0.3 pp). The drop was prompted mainly by the cut in prices of cigarettes and medicaments and the absence of electricity price adjustment over the past year.

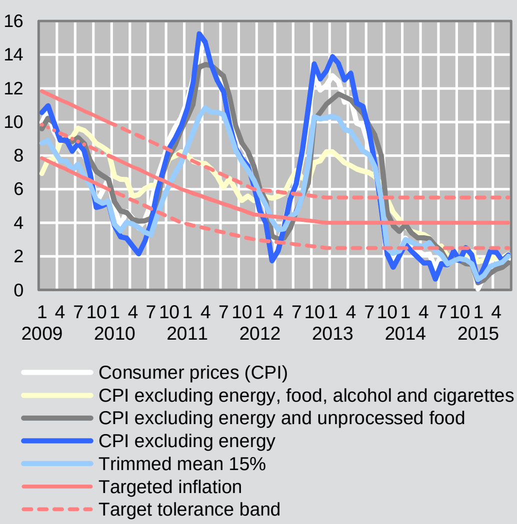
Though higher than headline inflation, y-o-y core inflation[5] (the part of inflation under the strongest impact

Table II.3.1 **Growth and contribution of components to consumer price growth in H1 2015**

	Growth rates (%)	Contribution (pp)
Consumer prices (CPI)	**2.1**	**2.1**
Unprocessed food	8.3	1.0
Processed food	2.0	0.4
Industrial products excluding food and energy	0.8	0.2
Energy	1.4	0.2
Services	0.9	0.2
Core inflation indicators		
CPI excluding energy	2.2	19
CPI excluding energy and unprocessed food	12	0.9
CPI excluding energy, food, alcohol and cigarettes	0.5	0.2
Administered prices	0.7	0.1

Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

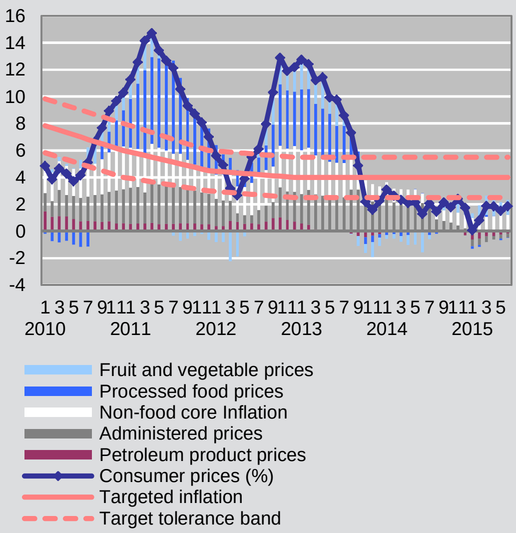
[5] Core inflation is measured as a change in the consumer price index, excluding prices of energy, food, alcohol and cigarettes.

of monetary policy measures) also continued to move below the lower bound of the target tolerance band and measured 2.1% in June.

In January–June 2015, overall growth in consumer prices amounted to 2.1%, reflecting mainly the rise in food prices (4.3%). The contribution of this category to six-month inflation was 1.4 pp, i.e. two-thirds of the overall price growth in H1, of which fruit and vegetable prices accounted for 1.3 pp.

Broken down by quarter, consumer prices rose by 1.4% in Q1 as unprocessed food prices (fruit and vegetable) went up following the seasonal dynamics. In Q2, consumer prices gained 0.7%, chiefly due to the seasonal upturn in prices of travel packages and higher cigarette and petroleum product prices. In contrast to Q1, the contribution of food prices was broadly neutral in Q2.

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



Sources: SORS and NBS calculation.

As inflation was moving below the lower bound of the target tolerance band for six consecutive months – from September 2014 to February 2015, in accordance with the Agreement between the National Bank of Serbia and the Government of the Republic of Serbia on Inflation Targeting, in March the NBS wrote a letter to the Government in order to explain why inflation moved away from the target tolerance band, outlining the measures to be taken to bring inflation within the target band and keep it therein in the medium run, including the period within which the NBS expects inflation to return within the band. The NBS underlined that inflation had been moving below the lower bound of the target tolerance band primarily on the back of two temporary factors: the absence of administered price growth and falling global oil prices.[6]

Price stability being a prerequisite to sustainable economic growth, the NBS is firmly committed to keeping inflation at a low and stable level. Under the NBS projection, y-o-y inflation will move around the lower bound of the target tolerance band over the coming year. It may enter the target band late this year or early next year. In H2 2016, it is expected to gradually come closer to the 4% target. It is likely that administered prices (electricity and cigarettes) will be the main inflationary factor. Medium-term price growth will be slowed by low aggregate demand, including subdued inflation in the international environment and tight fiscal policy at home.

[6] See Appendix 2, p. 35.

III. Macroeconomic environment

1. International environment

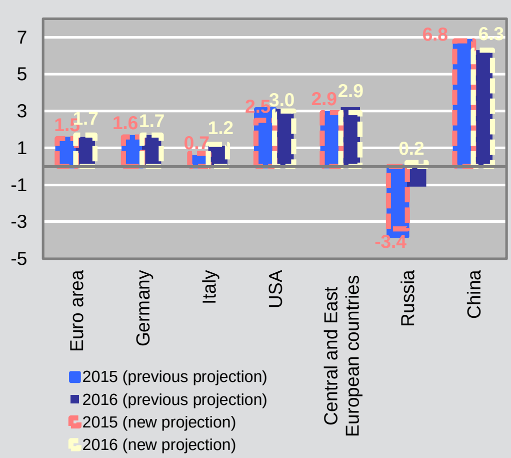
The recovery of **euro area economic activity** was gradually gaining momentum in H1 thanks to monetary policy accommodation by the ECB, falling global oil prices and euro's weakening against the leading world currencies. Led by domestic demand, GDP grew 0.4% s-a in Q1. It, however, slackened somewhat in Q2 – to 0.3% s-a under the preliminary assessment. Higher disposable household income and improved financial position of enterprises, reflecting a fall in oil prices and lower costs of borrowing, spurred a rise in private consumption and investments. In contrast, net exports gave a negative contribution amid dented global demand. Observed by country, economic recovery seemed more evenly spread than before, as all major euro area economies are on the track of sustainable growth. Germany and Spain experienced GDP growth in each of the two quarters (0.3% and 0.9% s-a in Q1 and 0.4% and 1.0% s-a in Q2, respectively). After three years, Italy exited recession in Q1, while France reported stagnation in Q2 following relatively strong growth in Q1 (0.6% s-a).

The situation in the labour market was relatively unfavourable in H1 as well. Despite a 0.3 pp reduction since early 2015, the unemployment rate remained high at 11.1% in June. Moreover, faster recovery of the euro area was hindered by continued geopolitical tensions in Ukraine, the slowdown in economic growth in BRICS countries and escalation of the debt crisis in Greece, which in the meantime lessened after the agreement was reached on the new rescue package.

Though negative in Q1, euro area inflation moved into positive territory in May (0.3% y-o-y), but declined slightly in June – to 0.2% y-o-y. The main factor behind low inflation was a fall in global oil prices. Still, the risk of prolonged deflation was averted thanks to monetary policy measures which prevented second-round effects on other prices.

US economic growth slackened in Q1 (0.15% s-a) due to a spell of cold weather, which impeded production and transport, slowing down the growth in private consumption. Further, as the dollar strengthened against major world currencies, exports declined as well. Up by 0.9% s-a in Q2, GDP was led by faster growth in private consumption and fixed investments, as well as by the

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



Sources: IMF WEO (April 2015) and IMF WEO Update (July 2015).

recovery of exports. H1 saw further improvement in the labour market as the unemployment rate fell by 0.3 pp to 5.3% in June, while the average number of new non-agricultural jobs continued above 200,000 per month. Along with reduced import prices resulting from dollar's appreciation, the fall in oil prices generated disinflationary pressures in H1. In the major part of H1, y-o-y inflation moved below or close to 0%. It returned into positive territory only in June (0.1%). Short-term inflation is expected to stay low. In the medium run, with waning of the effect of reduced oil prices and further improvement in the labour market, inflation is likely to return to the 2.0% target.

Economic growth of the majority of **Central and Eastern European countries** slowed in H1 relative to end-2014 over adverse effects of the geopolitical crisis in Ukraine. Still, accelerated euro area recovery spilled over to that region as well. The highest growth was observed in Central European countries that foster strong links with the euro area, whereas the Baltic countries experienced more moderate growth given their relatedness with Russia. The Russian economy faced negative trends in H1 – on the back of tumbling oil prices, which reflected on export revenue. Moreover, the rouble depreciated and economic sanctions restrained the access of Russian enterprises to the international financial market.

Deflationary pressures prevailed also in Central and Eastern Europe in H1, but gradually began to weaken as of Q2. In the course of Q2, y-o-y inflation moved into positive zone in Hungary, the Czech Republic, Macedonia and Montenegro. It stagnated in Croatia. Bulgaria recorded the highest deflation, extending into almost two years already. On the other hand, currency depreciation pushed up inflation in Ukraine, Russia and Turkey.

Deflationary pressures in the euro area and Central and Eastern Europe largely determined the character of **monetary policy of the ECB** and **central banks across the region**. To combat weak economic growth and low inflation, the ECB launched in March the programme of purchasing government securities of EU member states, while at the same time continuing to implement the asset-backed securities purchase programme and the covered bond purchase programme. Purchases under these programmes were planned at EUR 60.0 bln per month until and including September 2016 (completion date), in order to inject around EUR 1,100 bln into the system. As at end-June, the ECB had purchased around EUR 300 bln worth of these securities. At the same time, falling oil prices and low inflation, in addition to ECB's accommodation measures, made it possible for central banks from the Central and Eastern European region as well to continue with monetary policy easing. Cuts in policy rates in H1 were noted in Romania (100 bp to 1.75%), Turkey (75 bp to 7.5%), Hungary (60 bp to 1.5%) and Poland (50 bp to 1.5%). To support economic activity, the Bank of Russia also lowered its key rate, by 550 bp to 11.5%.

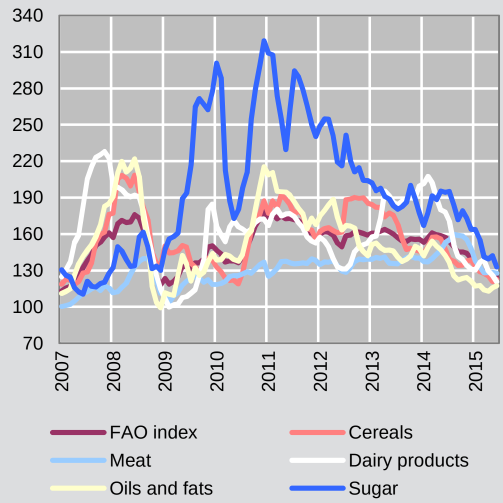
In contrast, after it ended the quantitative easing programme in 2014, in H1 2015 the **Fed** began to hint at an interest rate increase in the course of the year. Still, to temper market response, it was highlighted that possible monetary tightening would be gradual.

Divergent monetary policies of the ECB and Fed reflected on **currency markets** in terms of euro's weakening against the dollar. End-of-period, the euro lost 8.6% against the dollar in H1. In mid-March, it reached its lowest value since 2003 (1.05 dollars for one euro). However, the euro picked up somewhat in Q2 – by 3.6% against the dollar, on account of expectations that the Fed's rate increase would be postponed over the worse than expected performance of the US economy in Q1.

Currency markets went into turmoil in January on the back of the Swiss National Bank's decision to remove the 1.20 francs per euro cap. The Bank assessed that the franc's overvaluation was reduced since the cap was introduced (September 2011) and that the economy was capable of adapting to new market conditions. The decision brought about the franc's appreciation to around 1.05 for one euro – the level maintained through the major part of H1. Such trends also weighed down on credit markets of some Central and Eastern European countries where a part of banks' portfolio is franc-denominated as the franc's appreciation raised the price of loan servicing.

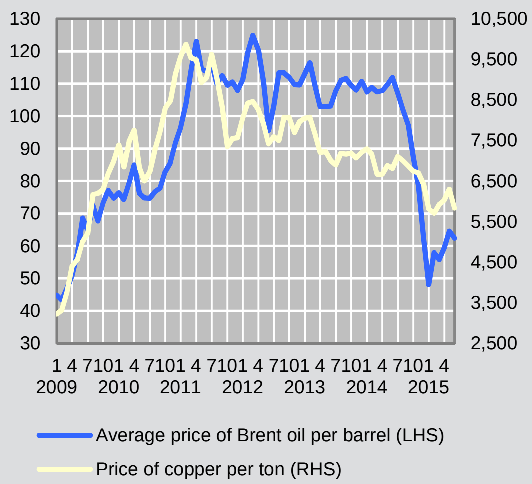
Measured by the FAO index, **world food prices** recorded a continuous decline in H1 and were by 11.4% lower in real terms in June relative to end-2014. Sugar prices fell the most (18.9%), reflecting elevated production in Brazil, the world's leading producer and exporter of sugar. World meat prices dropped as well (13.8%), due to depressed demand from Asia and Russia. Prices of dairy products also declined (8.0%) on account of lifted EU milk quotas, continued Russian import ban and reduced demand from China. Prices of cereals lost 11.5% on account of substantial inventories from the previous

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



Source: FAO, UN.

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



Source: Bloomberg.

season and generally good prospects for this year's yield. The weakest decline was noted for vegetable oil prices (3.1%), primarily due to adverse weather conditions in the leading producer countries.

In early 2015, **global Brent oil prices** continued down from H2 2014, reaching their lowest value in the past five years. The main reasons for the vigorous decline were substantial inventories worldwide, the OPEC's unwillingness to cut down on production and slower than expected global growth. However, oil prices have been on a rise since late January, experiencing smaller volatility in H1 and moving between 50 and 65 dollars per barrel, which was still much below the last-year figures.

World **copper prices** fell by around 10% in H1 notably due to the slowdown of China's economy, the world's largest consumer and importer of copper. The downward trend was also due to dollar's appreciation and the expected rise in production, prompted by lower energy costs.

Reflecting instability in financial markets in January, the **price of gold** increased by around 5% in that month. However, in the remainder of H1, on the back of dollar's strengthening and hints at the Fed's rate hike this year, investors shifted to higher-yielding assets, which resulted in reduced demand for gold. The price of gold was by around 2.9% lower in H1 than in late 2014.

2. International transactions

Balance of payments and FX reserves

External imbalances narrowed further in H1. According to preliminary data[7], the current account deficit amounted to EUR 728.0 mln in H1 (4.7% of GDP), down by around 30% compared to the same period last year. The deficit declined thanks to a higher surplus on the trade in services and the surplus on the secondary income account, including the narrowing of the deficit on the primary income account. At the same time, the deficit on the trade in goods edged slightly up. Unlike in the same period last year, the capital and financial account saw a net capital inflow. Favourable balance of payments trends added to an increase in NBS FX reserves.

Falling global oil prices and gradual economic recovery of our main foreign trade partners (the euro area and CEFTA) had a positive impact on the foreign trade deficit. Still, mainly due to lower exports of motor vehicles and electricity, the deficit was slightly higher than a year before. Exports of goods amounted to EUR 5.6 bln in H1, or EUR 309.0 mln more than in the same period last year. At the same time, imports went up by EUR 326.5 mln to EUR 7.5 bln, which reflected on a moderate increase in

[7] Balance of payments data are presented according to the new methodology (BPM6).

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

	January–June	
	2014	**2015**
I CURRENT ACCOUNT	-1,037.0	-727.9
1. Goods	-1,898.2	-1,916.0
1.1. Credit	5,278.8	5,587.6
1.2. Debit	7,177.1	7,503.6
2. Services	141.6	250.6
2.1. Credit	1,679.9	1,931.2
2.2. Debit	1,538.4	1,680.6
3.Goods and services	-1,756.7	-1,665.4
3.1. Credit	6,958.8	7,518.8
3.2. Debit	8,715.4	9,184.2
4. Primary income	-745.0	-698.1
4.1. Credit	292.9	263.2
4.2. Debit	1,037.9	961.3
of which: interest	458.5	528.7
5. Secondary income	1,464.6	1,635.6
5.1. Credit	1,640.4	1,841.2
5.2.Debit	175.7	205.6
II CAPITAL ACCOUNT	3.5	3.7
III FINANCIAL ACCOUNT (excluding reserve assets)	277.7	-486.1
1. Direct investment, net	-705.9	-675.4
1.1. Net acquisition of financial assets	115.2	66.9
1.2. Net incurrence of liabilities	821.1	742.3
2. Portfolio investment, net	-142.4	-132.7
2.1. Net acquisition of financial assets	4.9	80.6
2.2. Net incurrence of liabilities	147.3	213.3
3. Financial derivates, net	-2.3	5.9
3.1. Net acquisition of financial assets	-1.8	5.9
3.2. Net incurrence of liabilities	0.5	0.0
4. Other investment, net	1,128.3	316.1
4.1. Trade credit and advances, net	108.0	-15.1
4.1.1. Net acquisition of financial ass	376.0	404.5
4.1.2. Net incurrence of liabilities	268.0	419.6
4.2. Financial loans, net	758.6	183.0
4.2.1. Net acquisition of financial ass	-37.4	15.2
4.2.1.1. Long-term	-37.3	5.6
4.2.1.2. Short-term	0.0	9.6
4.2.2. Net incurrence of liabilities	-795.9	-167.8
4.2.2.1. Long-term	-752.4	-246.3
4.2.2.2. Short-term	-43.6	78.5
4.3.Currency and deposits, net	261.7	148.1
4.3.1. Net acquisition of financial ass	217.9	97.6
4.3.2. Net incurrence of liabilities	-43.8	-50.5
IV Reserve assets	-1,170.4	78.7
V NET ERRORS AND OMISSIONS	140.7	316.8
VI OVERALL BALANCE	1,170.4	-78.7

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

the deficit on the trade in goods (EUR 17.8 mln). The export-import ratio rose from 73.6% in H1 2014 to 74.5% in H1 2015.

Exports of goods rose primarily due to good last year's agricultural season and elevated exports of agricultural and food products and tobacco. In addition, favourable movements in the world steel market led to renewed production in the Smederevo steel plant. As a result, iron and steel exports saw robust growth in H1. These products together accounted for 73.3% of exports growth in H1. Exports of industrial machinery, non-ferrous metals and furniture increased less. A positive contribution to a reduction in foreign trade imbalances again came from exports of chemical and pharmaceutical products and rubber and plastic products. In contrast, exports of motor vehicles slumped due to lower demand for the car make currently produced in Serbia, as well as exports of electrical equipment over reduced demand from Russia. Furthermore, owing to falling oil prices and subsequently lower prices of petroleum products, the value of exports of this product group declined, whereas the flood damage to the energy sector weighed down on electricity exports. Still, as the production of electricity recovered, its exports recorded y-o-y growth in May and June.

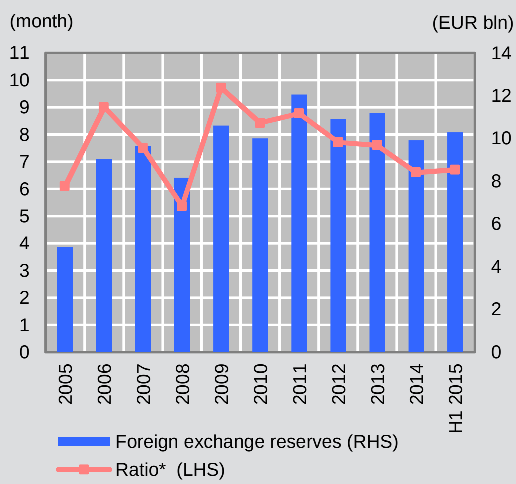
A y-o-y rise in imports of goods in H1 was fuelled primarily by elevated natural gas imports because of increased consumption in the chemical industry and the production of base metals, as well as increased electricity imports given that domestic production capacities did not fully recover in the first months of H1. Boosted production of base metals triggered a rise in imports of metal ore and scrap metal, coke and stone coal. A rise in imports was also recorded for industrial machinery, telecommunications and audio equipment, transport equipment, coffee and citrus fruit. On the other hand, the most significant contribution to the reduction in the foreign trade deficit came from lower imports of crude oil and petroleum products due to a fall in crude oil prices in the global market. Also, the increased production of base metals in the Smederevo steel plant led to partial substitution of iron and steel imports, while lower purchasing power of households bore down on imports of road vehicles.

The surplus on the trade in services provided further positive contribution to the current account (a y-o-y increase of EUR 109.0 mln in H1). Exports of services went up in almost all categories (EUR 251.3 mln), but most notably in transport, telecommunications and other business services. Exports of construction services rose on account of increased hiring of domestic enterprises for construction works abroad, while the spell of favourable weather and the extended winter tourist season reflected on an increase in exports of travel services. Imports of services increased (EUR 142.0 mln), most notably travel, transport and other business services, while imports of construction services fell from H1 2014.

The narrowing of the current account deficit in H1 also reflected trends in primary and secondary income accounts. The deficit was smaller on the primary income account (EUR 46.9 mln), while the surplus was higher on the secondary income account (EUR 171.0 mln). The primary income deficit fell to EUR 698.1 mln, notably due to a smaller deficit from direct investment income (EUR 99.4 mln). On the other hand, net outflows from portfolio investments increased (EUR 71.4 mln), partly because of the US dollar's appreciation. Expenses under income from other investments remained unchanged y-o-y. Owing to adequate reserve management and more favourable currency trends in the international financial market, H1 witnessed a rise in income from FX reserves (EUR 12.1 mln).

The surplus on the secondary income account went up from EUR 1.5 bln to EUR 1.6 bln, mainly due to a rise in remittances (EUR 117.0 mln) and the government's secondary income (EUR 35.8 mln). It is likely that the growth in remittances was not due entirely to the inflow of new remittances, but also to the inclusion of earlier

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



Sources: SORS and NBS.

*12-month moving averages.

received remittances into the payment system given the reduction in other sources of household consumption (wages and pensions). Apart from remittances, the surplus increased for current government transfers, mainly on account of a considerable inflow of official aid. As the surplus on the secondary income account increased, relative to H1 last year, its coverage of the deficit on trade in goods and services and primary income increased by 10.6 pp to 69.2%.

The capital and financial account (excluding changes in FX reserves) saw a net capital inflow of EUR 482.4 mln in H1, in contrast to the net outflow of EUR 281.2 mln in the matching period of 2014.

Net FDIs reached EUR 675.4 mln in H1, down by EUR 30.5 mln from the same period last year. Net direct equity investments increased by EUR 140.5 mln (to EUR 297.8 mln), while reinvested earnings fell by EUR 50.9 mln (to EUR 220.0 mln) and intercompany borrowing by EUR 120.1 mln (to EUR 157.6 mln). Unlike the same period last year when intercompany borrowing accounted for almost 40% of FDIs, this percentage declined in H1 as most FDIs (c. 77%) concerned equity investments and reinvested earnings. As in the prior period, most FDIs went into the industry, trade and financial sectors.

After recording a high net inflow in Q1 (EUR 473.8 mln), portfolio investments posted a net outflow in Q2 (EUR 341.0 mln), resulting in a net inflow of EUR 132.7 mln in H1, down by 6.8% y-o-y.

Net foreign debt repayment under financial loans amounted to EUR 167.8 mln in H1. All sectors apart from the government reduced their net external credit liabilities – the NBS by EUR 112.4 mln, banks by EUR 142.9 mln and enterprises by EUR 46.6 mln. The government raised its net credit liabilities by EUR 134.0 mln.

Balance of payments trends in H1 resulted in a EUR 78.7 mln increase in FX reserves (excluding cross-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 306.9 mln, resulting in a higher nominal rise in FX reserves of EUR 385.6 mln in H1. On 30 June 2015, NBS FX reserves stood at EUR 10,292.8 mln, covering around seven months of imports of goods and services. Net FX reserves increased by EUR 463.0 mln to EUR 8,120.0 mln in H1.

At end-June, foreign securities accounted for the largest portion of FX reserves – 67.3%, followed by FX balances in accounts abroad (NBS deposits and current accounts) – 22.0%, gold – 5.8%, foreign cash – 4.4%, and SDR – 0.5%. Consistent with the primary principles of safety and liquidity, funds are invested with top-tier institutions (central banks, international financial institutions and prime foreign banks) and in highly liquid securities issued by the most advanced countries in the world and international financial institutions.

The FX inflow from the sale of euro-denominated RS securities in the domestic financial market amounted to EUR 578.1 mln in H1. Inflows also came from NBS interventions in the IFEM (EUR 215.0 mln[8]), temporary payment transactions with Kosovo and Metohija[9] (EUR 173.7 mln), disbursement of loans extended to the Republic of Serbia (EUR 156.9 mln), grants (EUR 110.8 mln), investment in foreign securities and collection of interest on FX deposits (EUR 29.9 mln).

Liabilities to foreign creditors were settled in time (EUR 503.3 mln). The redemption of matured RS euro-denominated securities accounted for an outflow of EUR 387.9 mln. The payment of debt to the IMF (principle and interest) under the stand-by arrangement of 2009 accounted for EUR 109.9 mln. The servicing of frozen FX savings dragged FX reserves down by EUR 214.3 mln. The outflow on account of banks' withdrawal of FX required reserves came at EUR 59.7 mln net, and the repayment of government debt to domestic banks at EUR 30.8 mln.

International investment position

Serbia's international investment position of a net debtor was EUR 33.8 bln at end-June.

Net external financial assets went up by EUR 1.1 bln to EUR 19.5 bln in H1 – on account of net transactions (EUR 749.5 mln), cross-currency changes (EUR 245.6 mln), changes in asset prices (EUR 61.7 mln) and other changes (EUR 4.5 mln).

The sharpest rise within net financial assets was recorded for trade loans and advances. Rising by EUR 404.5 mln in H1, their stock reached EUR 1.5 bln by late H1, or 7.6% of total assets. This is followed by NBS FX reserves with over 50% of total assets. The bulk of the increase related to cross-currency changes (EUR 245.1 mln), net transactions (EUR 78.7 mln) and changes in asset prices (EUR 61.7 mln).

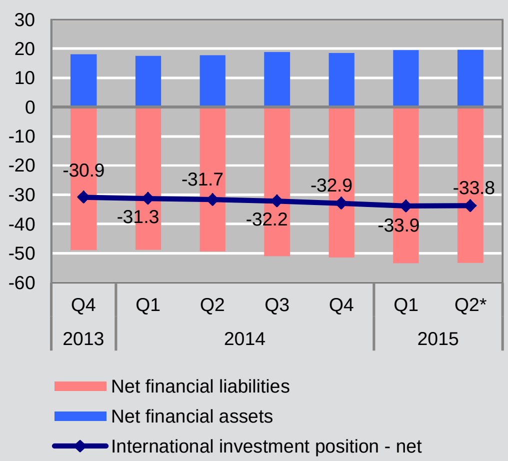
As in the same period last year, cash and deposits of residents (banks) abroad went up by EUR 97.6 mln to EUR 5.0 bln, which is why their share in total assets rose to 25.4%.

Resident direct investments abroad rose by EUR 66.9 mln. As a result, in late H1, receivables on these grounds amounted to EUR 2.4 bln or 12.3% of total assets. Resident portfolio investments abroad were up by EUR 81.3 mln to EUR 222.6 mln, and their share in total assets rose to 1.1%. Resident receivables under financial loans to non-residents (0.4%) continued to account for a smaller portion of total assets – they rose by EUR 15.2 mln to EUR 86.3 mln in H1.

Net external financial liabilities expanded by EUR 1.9 bln to EUR 53.3 bln, on account of higher net transactions (EUR 1.2 bln) and positive cross-currency changes (EUR 816.7 mln). Other changes led to a EUR 62.6 mln reduction.

The main changes in the structure of financial liabilities in H1 include an increase in FDI and portfolio

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



Source: NBS.
* Preliminary data.

[8] 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.

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

investment liabilities, as well as liabilities under financial loans and advances.

Liabilities under FDIs climbed by EUR 707.3 mln to EUR 25.0 bln, and their share in total liabilities amounted to 46.9%. Unlike the same period a year before, liabilities under equity investments (EUR 568.6 mln) increased more than under debt instruments (EUR 138.8 mln). At end-H1, liabilities under equity investments rose to EUR 18.9 bln (35.5% of total liabilities) and liabilities under debt instruments to EUR 6.1 bln (11.4% of total liabilities).

Resident liabilities (notably of the government) under non-resident portfolio investments rose by EUR 612.2 mln to EUR 8.0 bln (15.0% of total liabilities). However, almost two thirds of the increase is attributable to cross-currency changes rather than transactions. Trade loans and advances went up by EUR 419.0 mln to EUR 1.8 bln (3.4% of total liabilities).

Due to cross-currency changes of EUR 352.1 mln, resident liabilities under financial loans also increased, although residents had paid their debt in terms of executed transactions (EUR 167.8 mln). Hence, resident liabilities under financial loans went up by EUR 194.7 mln to EUR 17.0 bln, or 32.0% of total liabilities. At the same time, only government credit liabilities went up by EUR 414.0 mln, chiefly due to cross-currency changes (EUR 280.0 mln). The NBS and banks repaid EUR 100.5 mln and EUR 119.8 mln respectively, while credit liabilities of enterprises remained largely unchanged.

Observed by sector, the government share in total liabilities was 32.3% at end-June. Government liabilities included liabilities in respect of external financial loans (EUR 9.3 bln), debt securities held by non-residents (EUR 7.4 bln) and the drawdown of SDR allocation (EUR 486.8 mln). The NBS share in financial liabilities fell to 0.3% and consisted mostly of liabilities under the long-term financial loan based on the 2009 arrangement with the IMF. Furthermore, bank liabilities in total liabilities fell to 15.7%, mainly due to a reduction in banks' liabilities under financial loans to EUR 2.4 bln. Bank liabilities consisted of FDIs (EUR 4.8 bln), non-resident deposits and short-term borrowing (EUR 792.7 mln) and portfolio investments (EUR 298.2 mln). Over a half of total liabilities was made up of liabilities of enterprises (51.7%), primarily FDIs (EUR 20.2 bln), liabilities under financial loans (EUR 5.2 bln) and trade loans (EUR 1.8 bln).

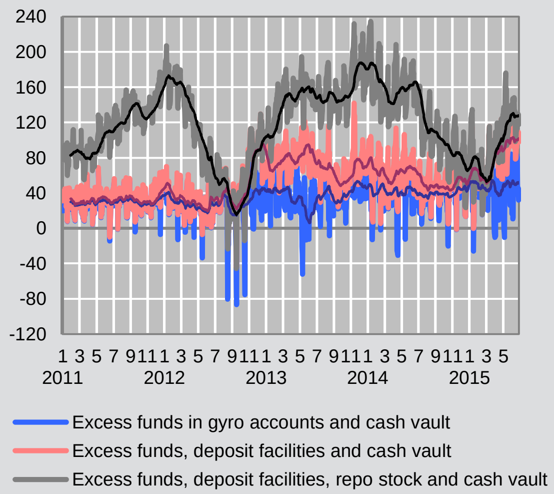
3. Financial market

Interest rates

Having declined slightly more than the key policy rate (2.0 pp) in Q1, the average repo rate[10] came at 4.0% at end-June, down by 2.2 pp from end-2014. At the same time, as banks' excess dinar liquidity subsided, no auctions were held from 25 February until early April. Thus, the decline in the average repo rate in the first repo auction held after a six-week break also reflected the March cut in the key policy rate.

At RSD 5.8 bln on average in H1, trading volumes in the interbank overnight money market were higher than a year earlier. Reduced excess dinar liquidity also influenced trading volumes in the interbank overnight money market, with average trading volumes rising until February. From March onwards, as banks' liquidity improved, trading volumes began to gradually decline, falling to a low of RSD 0.9 bln on average in May. After

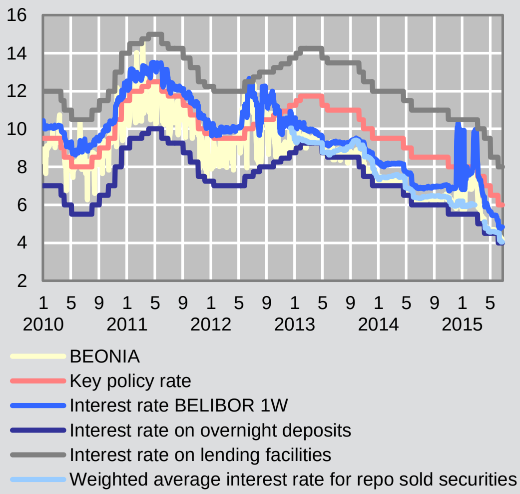
Chart III.3.1 **Dinar liquidity**
(daily stock and moving averages, RSD bln)



Source: NBS.

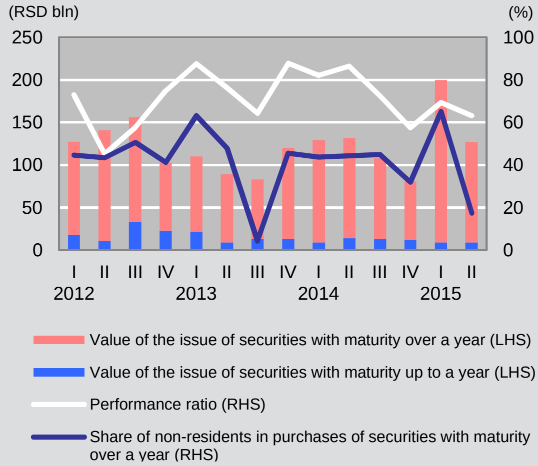
[10] The rate achieved at repo auctions weighted by the amount of the securities sold.

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



Sources: Thomson Reuters and NBS.

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



Source: Ministry of Finance.

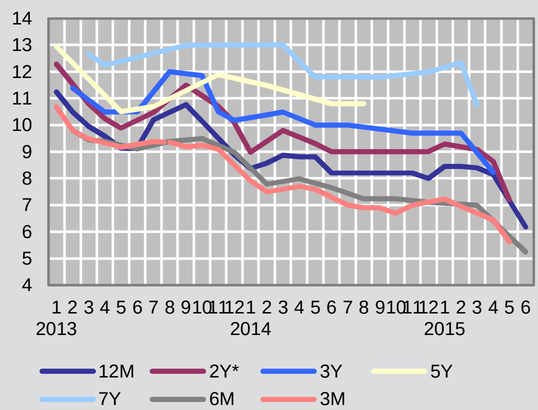
rising early in the year, *BEONIA* mirrored movements in the key policy rate for most of H1. As of March, *BEONIA* began to decline, averaging 4.4% in June or 3.0 pp down from December 2014.

BELIBOR rates moved along similar lines, decreasing in January, rising in February and falling from March onwards; in June, average *BELIBOR* rates ranged between 4.7% for the shortest and 6.3% for six-month maturity. The yield slope curve was moderated further during H1, on account of lower inflation expectations of the financial sector.

The NBS's May decision to narrow the interest rate corridor relative to the key policy rate from ± 2.5 pp to ± 2.0 pp also contributed to more stable movements in interbank money market rates in Q2.

Rates at auctions of dinar government securities organised early in the year were also rising mildly. From March they started to decline, as non-resident investment in these securities increased notably following the conclusion of the arrangement with the IMF and an increase in liquidity in the international market on the back of ECB's measures. At the same time, as non-residents invested more in longer-maturity securities in Q1, rates on seven-year securities declined the most (by 1.2 pp), down to 10.8% in March. The decline in rates continued into Q2, due not only to key policy rate cuts but also to an improved fiscal position. Positive effects of fiscal consolidation mitigated the risk of investment in government securities, while at the same time reducing

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

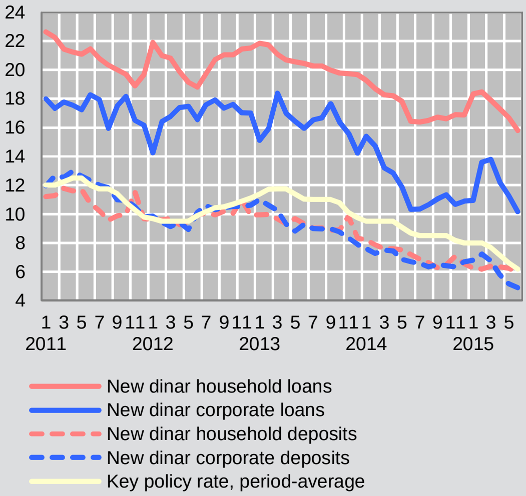


Source: Ministry of Finance.

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

government's need to borrow. The longest term over which the government borrowed in Q2 was three years – at a rate of 8.2% in April. In May and June, a smaller amount of securities was offered for sale. Auctions of six-month and one-year securities were held in June, at rates of 5.3% and 6.2%, down by 1.9 pp and 1.8 pp relative to end-2014. June also saw an auction of two-year amortised government bonds at a variable coupon linked to the key policy rate, in which the fixed margin was reduced to 1.2% annually from 1.4% at end-2014. Lower yields,

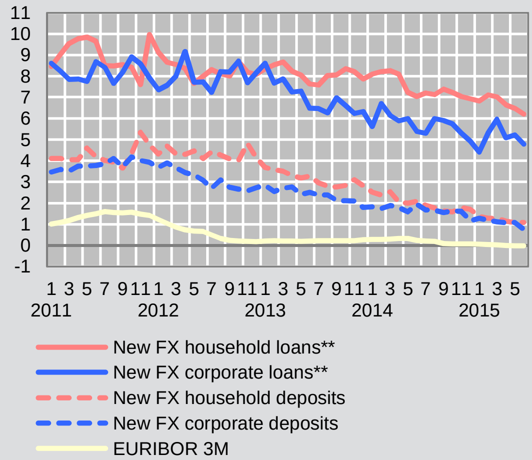
Chart III.3.5 **Interest rates on new dinar loans and deposits of corporates and households***
(weighted average values, p.a., %)



Source: NBS.

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

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



Sources: NBS and European Banking Federation.

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

** Euro and euro-indexed.

associated with shorter maturity and reduced volume of securities offered for sale, resulted in lower non-resident investment in government securities.

During H1, the government held eight auctions of euro-denominated securities in the domestic market. Rates in this market segment declined as well, mostly during Q2. The drop was the most pronounced for one-year securities (by 0.9 pp to 1.6%), while rates on two- and three-year securities fell by 0.6 pp each to 2.9% and 3.9%, respectively, and rates on five-year securities by 0.2 pp to 4.8%.

Rates in the secondary market of dinar securities mostly mirrored primary market rates. In June, they ranged from 5.2% for the remaining five-month maturity to 9.1% for 80-month maturity. Total trading volume in this market equalled RSD 168.3 bln. Most traded were three- and seven-year securities, in a period of increased non-resident presence in the market of government securities.

Interest rates on dinar loans spiked early in the year, with the wrap-up of the subsidised lending programme. The relatively low rates under this programme influenced the average price of loans during H2 2014. Rates on dinar loans fell more notably in Q2 following the decline in the key policy rate and interbank money market rates. At the same time, as household loans are costlier than the corporate, and their share in total new dinar loans went up, the average rate on dinar corporate and household loans came at 13.5% in June and was higher than at end-2014, despite a decline from March onwards.

The average rate on dinar corporate loans declined by 0.7 pp in H1 to 10.2%, below the level recorded in the period when banks were extending subsidised loans. Though falling in Q2, interest rates on dinar current assets loans and investment loans were slightly higher in June than at end-2014, equalling 10.8% and 10.5%, respectively, while the price of other loans decreased by 3.4 pp in H1 to 9.3%. The average rate on household loans was 15.8% in June, down by 1.1 pp from end-2014. All rates on dinar household loans were on a decline, ranging in June between 11.8% on housing and 16.6% on the most popular, cash loans.

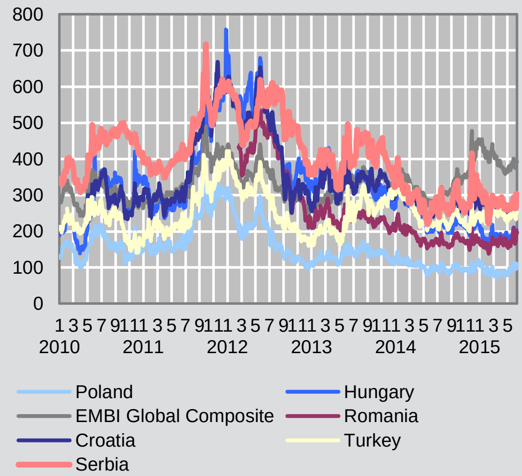
Rates on new loans in euros and dinar euro-indexed loans declined by 0.2 pp from end-2014 to 4.9% in June. The average price of corporate loans declined by the same amount, to 4.8% in June. Rates on almost all types of FX and FX-indexed corporate loans decreased – to 4.7% for current assets loans, and 4.3% for other loans, while the rate on investment loans was the only to increase on end-2014, rising to 5.4%. Households also borrowed at lower rates, which fell by 0.7 pp to an average of 6.2% in June. Rates on housing and other loans went down, while those on consumer and cash loans went up. As a result, end-June rates equalled 3.9%

for housing loans, 6.3% for consumer loans, 6.4% for cash loans and 9.1% for other loans.

Cheaper sources of funding for banks, reflected in lower deposit rates, were another factor behind the decline in lending rates, as confirmed by the results of the July bank lending survey. In late H1, average weighted interest rates on new deposits hit their lowest point since September 2010, i.e. since interest rate statistics were first released according to the current methodology.

Data on interest rates show that the drop was more pronounced for rates on new dinar deposits, which fell by 1.8 pp to 5.0% in June. Rates on dinar corporate deposits declined by 1.9 pp to 4.9%, and rates on household savings by 0.6 pp to 6.0%. The weighted average rate on new euro deposits declined less – by 0.6 pp to 0.9% due to falling rates on household savings (by 0.6 pp to 1.1%) and corporate deposits (by 0.4 pp to 0.7%).

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



Source: JP Morgan.

Country risk premium

Measured by the EMBI, Serbia's country risk premium broadly mirrored regional trends. End-2014 EMBI for Serbia was 312 bp, while its end-June value reached 297 bp. In terms of period-end, risk premium also declined in Hungary (17 bp), while in terms of period-average, risk premia of Poland (4 bp) and Romania (3 bp) dropped as well.

Early in the year, international developments were riddled with uncertainty regarding pace of economic recovery, effects of monetary policies and unexpected moves of leading central banks, as well as oil price movements in the world market and geopolitical tensions. As global uncertainty mounted, spurred additionally by Swiss National Bank's decision to scrap the lower bound of the exchange rate of 1.20 francs for 1 euro, financial markets reacted in January, pushing up *EMBI Global* and risk premia of Serbia and other countries of the region. Subsequently, with the announcement of ECB's decision to start quantitative easing and improved liquidity in the international financial market, risk premia of these countries diminished.

Implementation of fiscal consolidation measures, agreement with the IMF and affirmation of Serbia's credit rating early in the period, together with the subsequent successful first review of the arrangement with the IMF and an improved macroeconomic (primarily fiscal and external) position, all bolstered investor risk perception and contained the impact of potential turbulences in the international financial market.

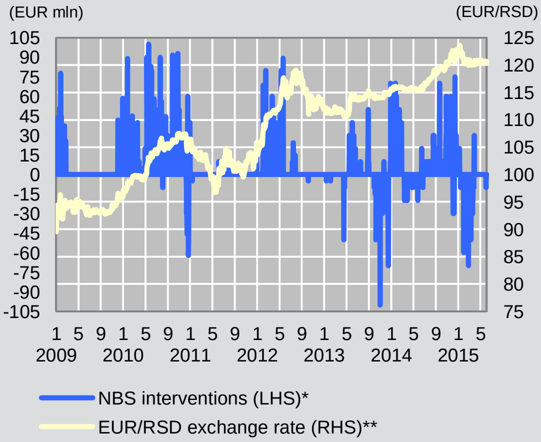
In January, *Fitch Ratings* affirmed Serbia's credit rating at B+ with stable outlook, while *Standard & Poor's* affirmed it at BB– with negative outlook. The affirmation of the rating was motivated by adopted fiscal consolidation measures, continued implementation of structural reforms and agreement with the IMF.

Trends in the FX market and exchange rate

Depreciation pressures from Q4 2014 continued into January, but in February and March the dinar strengthened. The rest of H1 was marked by stable exchange rate movements, which continued in the months that followed. In terms of period-end, the dinar gained 0.3% against the euro in H1, while in terms of period-average, it lost 1.8% relative to H2 2014.

The dinar weakened against the US dollar in H1, strongly affected by global factors. As the difference between euro area and US monetary policies widened, the dollar made strong gains against the euro in Q1. In Q2, the euro strengthened moderately against the dollar mostly because Fed deferred a rise in its policy rate. As the dollar gained 8.6% against the euro in H1, the dinar lost 7.7% against the dollar at end-June relative to end-2014.

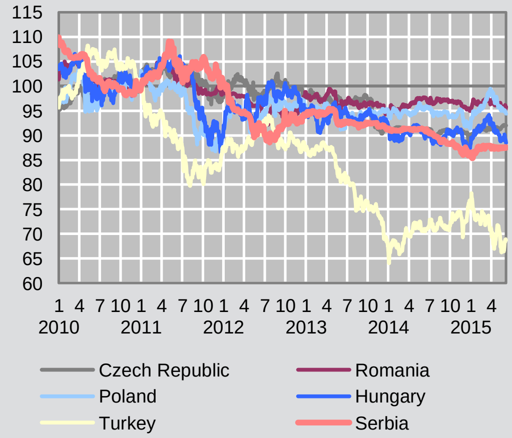
Chart III.3.8 **Movements in EUR/RSD exchange rate and NBS FX interventions**



Source: NBS.

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

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



Sources: NBS and websites of central banks.

* Growth indicates appreciation.

The January depreciation of the dinar against the euro was due to an interplay of domestic and global factors. There was an increase in FX demand by domestic enterprises, including primarily large energy importers. As trading volumes in the domestic FX market remained low, depreciation pressures mounted. In January, net non-resident investment in government securities also subsided.

In late January, the ECB announced its intention to expand its private asset purchase programme from March onwards to include bonds issued by euro area central governments. Improved liquidity in the international financial market resulting from ECB's measures and low yield rates on securities of developed economies encouraged greater flows of capital to emerging markets, including Serbia. A further boost came with the conclusion of a three-year stand-by arrangement with the IMF in the latter half of February, which also contributed to improved investor perception of Serbia. As a result, non-resident investment in domestic dinar securities was very high in February and March, pushing up non-resident demand for dinars. Reduced FX demand of domestic enterprises, a relatively low goods and services deficit and seasonally expected, high net foreign cash purchases by exchange offices in March, worked as additional factors of exchange rate stabilization until end-Q1.

Stability in the domestic FX market in Q2 was due to improved macroeconomic and fiscal prospects of the country, as confirmed by successful completion of the first review of the arrangement with the IMF in June and the affirmation of the country's credit rating by *Fitch* and *Standard & Poor's* in July. Balance-of-payments movements also improved, as current account deficit was significantly lower in Q2,[11] driven by a lower deficit in trade in goods, surplus on trade in services and elevated inflow of remittances. The inflow of remittances, but also the maturing of a new series of frozen FX savings bonds, resulted in higher purchases of foreign cash in exchange operations. At the same time, FX supply went up as well as a result of FDI inflows, while external government borrowing increased. Non-residents cut back on their investment in dinar government securities in Q2. Throughout the second quarter, particularly in June, they were net FX buyers from banks. This, however, did not weaken the dinar, partly because banks, faced with the

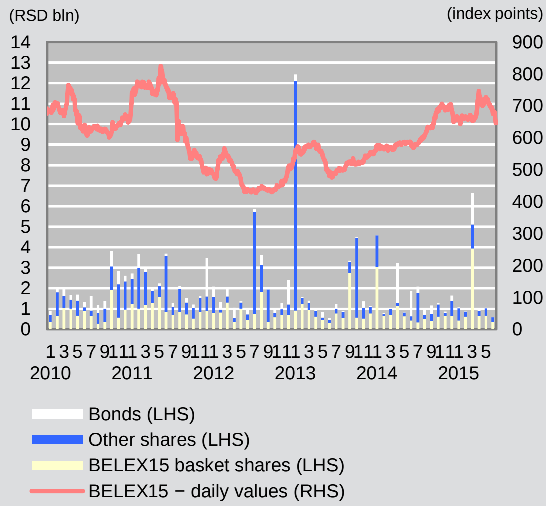
[11] May saw a current account surplus of EUR 17.1 mln. Last time a surplus was recorded in January 2005 when, due to the start of application of the VAT system in 2005, a part of imports was recorded in the preceding months.

maturing of earlier extended dinar subsidised loans and a rise in currency-indexed assets on other grounds, increased their FX supply.

IFEM trading continued on the recovery path in early 2015, with average daily interbank trading volumes[12] coming at EUR 36.7 mln in H1 or EUR 16.0 mln more than in the same period a year earlier. Exchange rate volatility[13], more pronounced late last year, subsided during H1.

To moderate excessive short-term exchange rate volatility, but without intending to influence the exchange rate trend, the NBS intervened in the IFEM by buying EUR 290.0 mln net in H1. After selling EUR 90.0 mln in January, until the end of H1 the NBS mostly bought foreign exchange in the IFEM (a total of EUR 410.0 mln). It intervened by selling only once, in April (EUR 30.0 mln).

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



Source: Belgrade Stock Exchange.

Stock exchange trends

At end-June, *BELEX15* (the index of the most liquid shares) came at 645.8 index points, or 3.2% down from end-2014. BELEXline (the general index of shares) declined somewhat less (1.2%), equalling 1,328.6 index points at end-H1. Belgrade Stock Exchange (BSE) indices remained broadly flat throughout Q1. They spiked in April, but began to decline around mid-May, as did the indices of most other regional stock exchanges, probably due to negative news about Greece's ability to service its obligations to creditors.

Total trading in shares on the BSE came at RSD 9.5 bln in H1. Trading volumes peaked in March (RSD 5.1 bln), mostly as a result of trading in the *open market*[14] segment, primarily with bank shares. Of total trading in shares, RSD 6.6 bln related to the most liquid shares.

Foreign investors accounted for around 50% of total trading in shares. By contrast to H2 2014, they were net sellers of domestic shares worth RSD 3.8 bln, mostly as a result of net sale of shares in March.

Total trading in frozen FX savings bonds came at RSD 1.7 bln and mostly (96%) related to trading in bonds maturing in May this year. Yield rates for the remaining A2016 series stayed unchanged from end-2014 at 2.9% at end-June.

BSE market capitalisation declined by RSD 76.0 bln to RSD 720.6 bln at end-June. Regulated market capitalisation shrank by RSD 74.7 bln to RSD 375.4 bln, mostly as a result of maturing of A2015-series bonds in May, but also due to the exclusion of shares of certain issuers from trading in previous months. MTP capitalisation[15] went down by RSD 1.3 bln to RSD 345.1 bln. As a result of such movements, the share of market capitalisation in estimated GDP[16] edged down by 2.0 pp to 18.5% at end-H1.

4. Money and loans

Reserve money

In H1, dinar reserve money expanded by 7.4% in nominal and 5.2% in real terms. The increase in total reserve money in H1 (by 5.2% in nominal and 3.1% in real terms) was due primarily to movements in dinar reserve money.

[12] Excluding NBS.

[13] Measured by *EWMA* and *EGARCH*. *EWMA* (*Exponentially Weighted Moving Average*) – method of weighted moving averages where percentage daily changes in the exchange rate are assigned different weights for different points in time, with weights declining exponentially the further they are from the present moment. *EGARCH* (*Exponential General Autoregressive Conditional Heteroskedasticity*) – method of estimating conditional variance showing the asymmetrical effect of positive and negative shocks on conditional variance estimation.

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

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

[16] Estimated GDP in the last four quarters.

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

	Dec. 2014	June 2015	Changes in H1 2015
Net foreign assets	**1,181,851**	**1,239,294**	**57,443**
Net FX reserves	1,179,936	1,235,146	55,210
Gross FX reserves	1,198,357	1,241,352	42,995
IMF loans	-18,421	-6,206	12,215
Other net foreign assets	1,915	4,148	2,233
Net domestic assets	**-572,391**	**-597,964**	**-25,573**
Net domestic NBS loans	-278,220	-276,639	1,581
Net loans to government[1)]	-256,415	-239,288	17,127
Government loans	1,223	1,246	23
Government deposits	-257,638	-240,534	17,104
Net claims on banks	-6,889	-17,415	-10,526
Loans to banks	625	4,704	4,079
Repo operations	-7,500	-20,000	-12,500
Other securities	-14	-2,119	-2,105
Loans to public enterprises	1,183	1,251	68
Loans to non-bank financial institutions	2,562	3,527	965
Loans to other sectors	1,168	1,142	-26
Term and restricted deposits	-19,829	-25,856	-6,027
Other net assets	-294,171	-321,325	-27,154
Reserve money	**609,460**	**641,330**	**31,870**
Dinar reserve money	370,690	397,984	27,294
Currency in circulation	130,468	118,956	-11,512
Dinar reserves of banks	211,628	244,633	33,005
Required reserves	158,126	163,468	5,342
Excess reserves	53,502	81,165	27,663
Other deposits of other sectors	2	4,353	4,351
Local government deposits	28,592	30,042	1,450
FX bank deposits	238,770	243,346	4,576

1) Excluding local government authorities.
Source: NBS.

In absolute terms, dinar reserve money increased by RSD 27.3 bln and total reserve money by RSD 31.9 bln.

Dinar reserve money increased primarily on account of NBS's net FX purchases in the IFEM (RSD 25.5 bln) and payment transactions with Kosovo and Metohija (RSD 20.9 bln). Government dinar deposits with the NBS were on the rise until April, largely under the positive effect of fiscal consolidation. In May and June, dinar deposits shrank, after a sizeable portion of these funds was used for FX purchases, mostly for the purpose of redeeming due frozen FX savings bonds. As a result, the government mopped up RSD 21.0 bln of liquidity in H1. RSD 12.5 bln was withdrawn through open market operations.

In terms of composition of dinar reserve money, banks' excess dinar reserves[17] increased most in H1 (RSD 27.7 bln), mostly on account of higher overnight bank deposits with the NBS. Bank gyro account balances decreased. Dinar allocations of required reserves went up (RSD 5.3 bln), as did account balances of other sectors (RSD 4.4 bln) and the local government (RSD 1.5 bln). Currency in circulation declined by RSD 11.5 bln.

Monetary aggregates M1, M2 and M3

The dinar share of money supply declined in H1. Although balances on transaction deposits went up, M1 shrank by 3.4% in real terms due to a decline in currency in circulation. Additionally, the drop in savings and time deposits prompted a sharper fall in M2 – 9.1%. M1 and M2 determined movements in the broadest money aggregate. Although FX deposits increased from end-2014, M3 rose marginally in nominal (0.6%) and fell by 1.5% in real terms in H1.

The slowdown in y-o-y money supply growth, begun in August last year, continued into H1, after a short break in early 2015. The slowdown was more pronounced for dinar monetary aggregates whose y-o-y growth in June came at 4.3 % for M1 and 5.2% for M2. The broadest monetary aggregate M3 was 4.2% higher in real terms in June relative to the same period a year earlier.

M3 decreased in H1, as a result of lower private sector lending and higher government deposits with the NBS. On the other hand, increased bank investment in government securities and the rise in net foreign exchange reserves of the NBS and banks acted in the opposite direction.

A breakdown by M3 component shows that demand deposits increased by RSD 5.6 bln. Most of this increase was generated in company accounts from manufacturing and agriculture. Balances on accounts of local government bodies and non-profit organisations also

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

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

	Dec. 2014	June 2015	Changes in H1 2015
Net foreign assets	**1,036,784**	**1,099,719**	**62,935**
Bank net foreign assets	-145,067	-139,574	5,493
Net domestic assets of the banking sector	**828,659**	**776,397**	**-52,262**
Net domestic loans	2,048,254	2,065,869	17,616
Net claims on government	122,670	146,952	24,283
Government loans	458,249	469,025	10,776
Government deposits	-335,580	-322,073	13,507
Loans to other resident sectors	1,925,584	1,918,917	-6,667
Loans to households	725,455	746,503	21,048
Loans to the corporate sector	1,140,200	1,112,339	-27,861
Loans to other financial corporations	23,588	25,329	1,741
Loans to local authorities	35,246	33,244	-2,002
Loans to non-profit and other organisations	1,095	1,502	407
Other net assets	-1,219,594	-1,289,472	-69,878
Money supply M3	**1,865,443**	**1,876,116**	**10,673**
Money supply M2	614,259	595,302	-18,957
Money supply M1	430,915	425,052	-5,863
Currency in circulation	130,468	118,956	-11,512
Transaction deposits	300,447	306,096	5,649
Dinar savings and term deposits	183,344	170,250	-13,094
FX deposits	1,251,184	1,280,814	29,630

Source: NBS.

increased. Companies, belonging mostly to the trade, manufacturing and construction industries, decreased their longer-term dinar deposits. This was the main reason behind the RSD 13.1 bln drop in this deposit category, despite the increase in savings and time deposits of other sectors.

Dinar savings resumed growth in April and have been on the rise ever since. They gained RSD 3.5 bln in Q2, reaching RSD 40.0 bln by late June, close to their July 2014 peak. Households mainly opted for three- six- and 12-24 month savings deposits. FX household savings gained EUR 122.7 mln from the start of the year, reaching EUR 8.4 bln by end-June. Of these, FX demand deposits and term deposits maturing between one and two years increased the most. Although a new series of frozen FX savings bonds fell due in May, this made no significant addition to household FX savings which gained EUR 30.5 mln in June. Lower wages and pensions are probably one of the reasons why FX household savings grew less than usual in the period of redemption of frozen FX savings bonds, which was confirmed by a higher volume of foreign cash purchases in exchange transactions.

Since the start of the year, corporate FX deposits also went up (by EUR 80.8 mln), partly owing to a rise in exports, as indicated by higher corporate deposits of companies in mostly export-oriented sectors.

The ratio of broad money (M3) to NBS foreign exchange reserves gained 1.9 pp since the start of 2015 to reach 66.2% in June. Including foreign exchange reserves of banks, this ratio increased from 75.5% to 77.0%. Monetary multiplier declined during H1 by 0.1 pp and 0.2 pp, reaching 1.1 for M1 and 1.5 for M2 in June. With the gradual recovery of economic activity, the velocity of circulation of dinar money supply subsided during H1, while remaining unchanged for the broadest monetary aggregate relative to end-2014.

Bank lending

Lending activity slowed again in early 2015 with the winding up of the subsidised lending programme. Signs of improvement appeared in June, when loans saw a monthly increase for the first time in the year, driven rather by corporate lending than by lending to households and OFOs.

Despite the June recovery, domestic loans, excluding the exchange rate effect, fell by RSD 21.9 bln or 1.1%[18] in H1, and their share in estimated GDP[19] by 0.3 pp to 48.1%.

The trend of y-o-y decline in domestic lending activity was discontinued in early 2015. However, y-o-y growth in lending slowed from April onwards to 0.6% at the

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

[19] Estimated GDP in the past four quarters.

programme exchange rate in June, with corporate lending slowing to 0.5% and household lending to 3.0%.

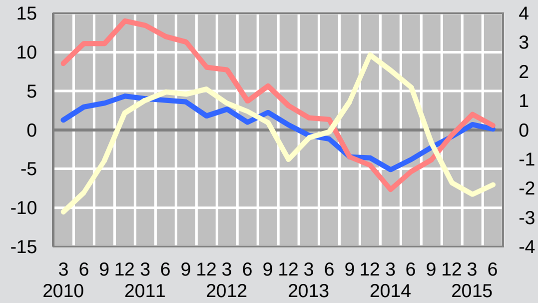
Lending activity is likely to decline by end-2015, with the maturing of some 80% of subsidised loans approved in the prior year. To contain this decline, the NBS is taking monetary policy measures by trimming the key policy rate and the required reserve ratio. The NBS has also taken part in drawing up the NPL resolution strategy to tackle this issue, as one of the key factors holding back growth in lending.

In H1, banks continued to rely on domestic sources of funding, including primarily FX corporate and household deposits.[20] At the same time, they increased their balances on dinar and FX accounts with the NBS. Banks also continued to channel a portion of available assets into government securities, and further reduced their foreign loan obligations, and, to a smaller extent, foreign receivables.

Excluding the exchange rate effect, corporate loans shrank during H1 by RSD 27.7 bln or 2.5%. Trends were more unfavourable early in the year when, as seasonally expected, fewer new loans were approved, and first instalments of subsidised loans came due, inducing a drop in bank receivables. Q2 saw more favourable movements, as confirmed by higher amounts of newly approved loans. At the same time, less than a quarter on average of newly approved loans in H1 were refinanced loans, i.e. loans with amended terms of repayment. Banks continued to approve most loans for current assets financing, which made up around 40% of new loans to corporates. A positive signal came from investment loans which upped their share (30%), while other types of loans accounted for around 27%.

Results of the NBS July bank lending survey[21] also point to more favourable trends in Q2. For the first time since the survey began, the banking sector reported a relaxation of corporate lending standards. Despite persistent risks associated with the collection of receivables and collateral and unfavourable outlook for future economic growth, a number of banks eased their standards driven by competition and cheaper sources of funding. As banks reported, margins and associated costs continued to

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



Sources: NBS and SORS.

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

** At programme exchange rate.

decline into H1, and corporates were also offered more favourable terms of repayment. At the same time, requirements regarding collateral and maximum loan amount were tightened. After falling in Q1, corporate loan demand increased in Q2, which, according to banks' assessment, was motivated by the need to finance current assets and refinance the existing liabilities.

By contrast to corporate loans, banks' receivables in respect of household loans increased by RSD 6.3 bln or 1.0% since the start of 2015. As in the prior period, cash loans were predominant, making up more than a half of newly approved loans (51%). Housing loans remained subdued, as expected, given the relatively low household income and unfavourable trends in the property market. Consumer loans upped slightly, as did costlier loan categories – revolving loans and credit cards. Current account overdrafts remained broadly unchanged from prior months. The amount of new loans increased in H1 relative to prior periods, partly as a result of modified terms of repayment of existing, mostly housing loans, following implementation of the NBS Decision[22] on measures for preserving stability of the financial system in the context of foreign currency-indexed loans.

[20] Loan-to-deposit ratio (LTD) declined to 110.2% in June, as a result of reduced lending and a broadly unchanged deposit base.

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

[22] Decision on Measures for Preserving Stability of the Financial System in the Context of Foreign Currency-Indexed Loans, adopted by the National Bank of Serbia in February 2015 to help households overcome difficulties caused by the unilateral increase of interest rate margins by banks, and problems in repayment of CHF-indexed loans. Subject to this Decision, banks are obliged to treat the amount overcharged in respect of unilateral increase of margins prior to the start of implementation of the Law on Financial Service Consumer Protection as early loan repayment, regardless of the currency to which the loan was indexed. Also, banks have an obligation to offer the choice of four types of modified terms of loan repayment to CHF-indexed loan users, while keeping in place the existing collateral. Two of these models involve conversion into euro-indexed loans, while the other two involve unchanged currency of indexation and a lowering of the interest rate and extension of the loan repayment term or a reduction of the monthly instalment over a three-year period and repayment of the amount of such reduction after the expiry of the original loan maturity.

According to the results of bank lending surveys, household lending increased owing to further easing of standards driven by the same reasons as in the case of corporate lending. Interest rate margins and accompanying costs shrank. Banks offered longer terms of repayment while keeping loan security terms – collateral, down-payment and mortgage – unchanged in Q2, after a tightening in Q1. According to banks, demand for almost all types of loans increased in Q2. Households opted most for cash and refinancing loans, while demand for housing loans also went up for the first time in three quarters.

According to survey responses, together with expectations regarding economic activity, non-performing receivables were the main factor hindering the relaxation of lending standards. In H1, the share of NPLs in total loans, gross, gained 1.2 pp to reach 22.8% in June. The share of corporate NPLs increased by 1.1 pp to 25.8% and that of household NPLs by 1.0 pp to 11.3%[23].

However, despite the high share of NPLs in total loans, the capital adequacy ratio of around 21% points to unimpaired stability of the domestic banking sector. In June, total allowances for loan impairment stood at 59.6% of NPLs. At 113.2% in June, loan loss provisions[24] continued to fully cover the amount of gross NPLs. The NPL Resolution Strategy, developed by the Serbian Government and the NBS, in cooperation with the IMF, WB and EBRD, and adopted by the Government in August 2015, is expected to offer a market-based and long-term sustainable solution to the problem of NPLs.

5. Dinarisation

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

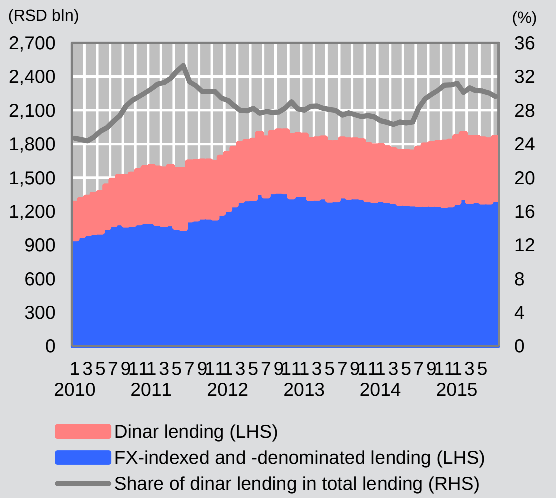
Recognising the need to increase the use of the dinar in the financial system in order to strengthen the country's financial stability, lessen the exposure of the most vulnerable sectors of the economy to the currency risk, reinforce the efficiency of monetary policy and, by extension, create preconditions for strong and sustainable economic growth, in April 2012 the NBS and the Government signed the Memorandum on the Strategy of Dinarisation of the Serbian Financial System[25].

In H1, through its required reserves policy, the NBS continued to encourage banks to use dinar sources of funding. Namely, despite the trimming of the FX required reserve ratio, required reserve ratios on dinar sources are still much lower than on FX ones, and the NBS remunerates banks for allocated dinar required reserves only.

The NBS continued to work on further development of basic FX hedging instruments. During H1, regular two-week and three-month FX swap auctions were organised, encouraging interbank swap trading and development of instruments for liquidity management and FX hedging.

The NBS uses the share of dinar lending in total corporate and household lending[26] as the key indicator of

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



Source: NBS.

[23] Including entrepreneurs and private households, the share increased by 0.9 pp to 12.3%.

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

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

[26] See: Report on Dinarisation of the Serbian Financial System, published quarterly by the NBS on its website: http://www.nbs.rs/internet/english/90/dinarizacija/index.html.

financial system dinarisation. In H1, the degree of dinarisation contracted from 31.2% at end-2014 to 29.6% at end-June 2015.

The degree of dinarisation declined as fewer new dinar loans were approved and the previously extended ones matured for repayment, including in particular the loans approved as part of the Government's subsidised corporate lending programme, which ended late last year. The degree of dinarisation of corporate lending decreased gradually from the start of the year – from 25.0% late last year to 21.7% at end-June.

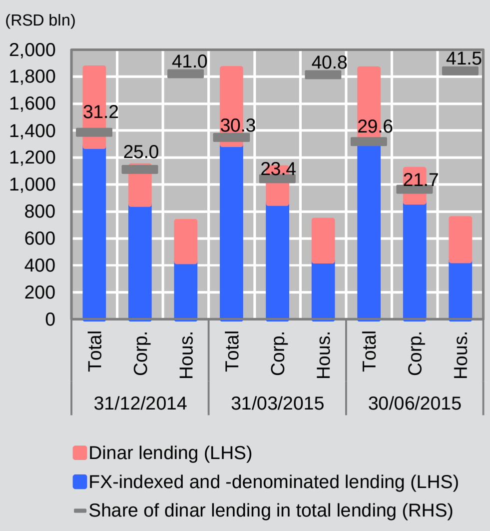
The degree of dinarisation of household lending increased in the same period (from 41.0% at end-2014 to 41.5% in late June this year), as dinar household lending increased slightly more than FX household lending.

Excluding the exchange rate effect[27], the degree of dinarisation fell from 31.2% at end-2014 to 29.9% in June 2015.

The share of dinar deposits in total corporate and household deposits also shrank in H1 (by 1.0 pp) to 23.5% in June. Dinarisation of corporate deposits declined more (by 2.5 pp to 51.1%) than that of household deposits (by 0.3 pp to 12.0%). Although it decreased at the level of H1, the share of dinar deposits in total corporate deposits began to rise from June onwards, while household demand picked up from April, with an increase in dinar household savings.

By contrast to the above dinarisation indicators, the share of dinar debt in total public debt increased mildly from end-2014 (by 0.1 pp) to 21.5% in June.

Chart III.5.2 **Lending by sector**



Source: NBS.

6. Aggregate demand

Private investment provided a positive contribution to aggregate demand in H1, while household consumption and government consumption and investment worked in the opposite direction. The contribution of net external demand was negative (0.1 pp), mainly because of increased imports of equipment. According to our estimates, growth in private investment is likely to continue until the end of the year. Together with recovery of net external demand, spurred by the faster economic growth of Serbia's key trade partners, and stepped up execution of capital projects, this should contribute to the expansion of aggregate demand in 2015.

Domestic demand

Continued implementation of fiscal consolidation measures led to a further decline in final consumption, which measured 1.4% y-o-y in H1. At the same time, household consumption lost pace to 0.9% y-o-y relative to 1.3% y-o-y in H2 2014, which can be linked to the smaller drop in real disposable income of households following the collapse of global oil prices. Besides, H1 saw an improvement in the main sources of consumption – real net wage bill of the non-public sector increased by 2.6% y-o-y and inflows from remittances picked up. Observed by quarter, household consumption fell in Q1 (1.7% s-a) and then inched up in Q2 (0.8% s-a).

Final government consumption contracted in H1 by 3.3% y-o-y, largely as a result of a cut in labour costs in the public sector (12.1% y-o-y), while the drop in outlays for the purchase of goods and services amounted to 0.9% y-o-y. At quarterly level, this component of demand

[27] At the constant exchange rate of December 2014.

followed a path similar to that of household consumption – after declining by 3.3% s-a in Q1, it edged up by 0.1% s-a in Q2.

The strongest positive contribution to aggregate demand in H1 (1.4 pp) stemmed from private investment, which climbed by 9.3% y-o-y. This is signalled by construction industry indicators – the value of works performed rose by 10.6% y-o-y, the production of construction materials by 1.1% y-o-y, and the number of issued construction permits by 11.8% y-o-y. Imports of equipment also marked an increase in H1 (16.4% y-o-y). The recovery of investment activity in H1 is attributable to a certain extent also to enhanced business environment following the adoption of reform laws in 2014, as well as to improved financial position of enterprises underpinned by lower oil prices.

Government investment decreased by 13.5% y-o-y in H1 amid somewhat slower execution of capital projects in Q1, which is indicated by the 14.1% s-a drop in that quarter. However, after soaring by 50.2% s-a in Q2, government investment is expected to provide a positive contribution to aggregate demand at annual level.

Table III.6.1 **GDP distribution in H1 2015**

	Growth rates (%)	Contribution to GDP growth (pp)
GDP at constant, previous year prices	**-0.4**	**-0.4**
Domestic demand	-0.3	-0.3
Total final consumption	-14	-13
Private consumption	-0.9	-0.7
Government consumption	-3.3	-0.6
Investment	5.7	10
Fixed investment	6.6	12
Private investment	9.3	14
Government investment	-13.5	-0.3
Change in inventories	-	-0.1
Net exports (exports - imports)	-13	-0.1

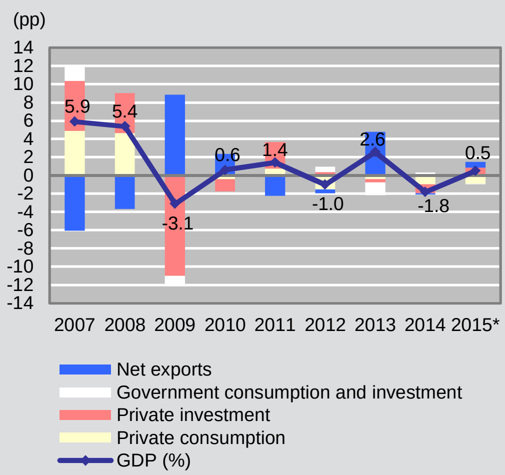
Sources: SORS and NBS calculation.

Net external demand

Net external demand made a negative contribution to aggregate demand movements in H1 2015 as the y-o-y growth in real exports of goods and services weakened from 12.8% in H1 2014 to 8.6% and the growth in real imports stepped up from 5.8% to 7.0%. Slowing export growth reflects a deceleration in exports of motor vehicles and petroleum products, while stepped up imports mirror stronger imports of equipment driven by increased investment.

Euro-denominated commodity exports rose by 8.1% y-o-y in H1, primarily thanks to robust exports of agricultural products (37.9% y-o-y) resulting from a good agricultural season last year. Corn exports rose by around 55% y-o-y to around 1.6 mln tons in H1, while wheat exports (some 130,000 tons) stayed broadly unchanged

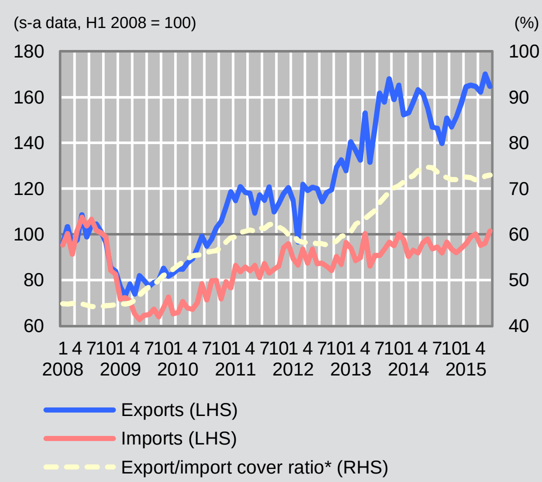
Chart III.6.1 **Contribution to annual GDP growth rate – expenditure side**



Sources: SORS and NBS calculation.

* NBS estimates.

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



Sources: SORS and NBS calculation.

* 12-month moving average.

from H1 2014. Vibrant y-o-y growth was also registered for exports of base metals following the restarting of production in the Smederevo steel plant, as well as exports of metal products, pharmaceutical products and preparations, and food and tobacco products. On the other hand, a decrease was recorded for exports of motor vehicles (4.3% y-o-y) which nonetheless remained Serbia's key export product (EUR 735.0 mln in H1). Serbia's exports of petroleum products were dented by the fall in global oil prices.

Euro-denominated commodity imports rose by 5.9% y-o-y in H1, owing chiefly to bolstered imports of equipment (16.4% y-o-y). Imports of intermediate and consumer goods went up by 1.7% and 1.9% y-o-y, respectively, while imports of unclassified goods soared by 39.1% y-o-y. Observed by economic destination of the EU, the strongest rise in imports was registered for durable consumer goods (21.9% y-o-y), as a result of higher imports of electrical machinery and appliances, whilst stronger imports of industrial raw materials (base and non-ferrous metals, non-metal minerals) gave impetus to imports of intermediate goods (5.7% y-o-y). Energy imports, on the other hand, were by 5.5% lower y-o-y because of falling global oil prices, while imports of natural gas and electricity showed an increase relative to H1 2014.

7. Economic activity

In H1, the mining-energy complex fully recovered from last year's floods. As a result, and along with further growth in manufacturing (which began in Q4 2014) and the recovery of the construction sector, economic activity measured by NAVA picked up by 0.4% y-o-y. However, the majority of service sectors witnessed a downturn relative to the same period last year, which along with the estimated fall in agricultural production drove down GDP in y-o-y terms.

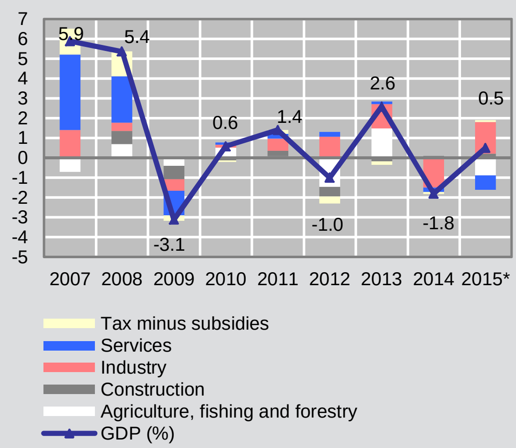
Broken down by quarter, following stagnation in Q1 (-0.1% s-a), GDP accelerated in Q2 (2.2% s-a). The main contributor was further industrial growth, prompted by lower prices of energy, the recovery of external demand and improved regulations in the field of construction which had a positive bearing on construction activity. Following four quarters of decline, GDP edged up in y-o-y terms as well (1.0%), reflecting full recovery of production capacities in the mining and energy sectors from last year's floods and further growth in manufacturing aided by the euro area recovery.

Up by 1.9% y-o-y in value terms and 4.8% y-o-y in physical terms, industrial production added 0.4 pp to GDP. In contrast, the physical volume of production declined in the mining sector (3.4% y-o-y) as the exploitation of crude oil and metal ores contracted. At the same time, coal mining picked up, reflecting on a rise in the physical volume of production in the electricity, gas and steam supply sector (3.9% y-o-y).

Positive trends in manufacturing, set in train in late 2014, continued into H1 2015. Up by 6.2% y-o-y, the rise in the physical volume of production was broad-based – it was recorded in 18 of 24 areas, most of which are export-oriented. The main contribution came from the production of machinery, equipment and food. Somewhat weaker growth was also observed for the production of tobacco products, pharmaceutical products and preparations, metal, rubber and plastic products. Further, as positive trends in the world iron and steel market helped renew production in the Smederevo steel plant in July 2014, relatively vigorous growth in the physical volume of production in H1 (25.1% y-o-y) was also noted for the production of base metals. On the other hand, some slackening was seen in the production of motor vehicles, electrical equipment, and computers and electronic products.

In addition to industry, growth in the construction sector (6.1% y-o-y) also gave a positive contribution to GDP (0.2 pp), as shown by the majority of indicators – a larger number of issued construction permits, a higher value of

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



Sources: SORS and NBS calculation.
* NBS estimate.

Table III.7.1 **Economic activity in H1 2015**

	Growth rates (%)	Contribution to GDP growth (pp)
Gross domestic product (GDP)	**-0.4**	**-0.4**
Agriculture, forestry and fishing	-9.0	-0.7
Industry	19	0.4
Construction	6.1	0.2
Wholesale and retail trade; repair of motor vehicles and trailers, transportation and storage, accomodation and food services	11	0.2
Information and communication	-12	-0.1
Financial and insurance activities	2.3	0.1
Real estate activities	-0.4	0.0
Professional, scientific, innovation and technical activities, administrative and support service activities	-0.7	0.0
Public administration and compulsory social security, education, human health and social work activities	-3.4	-0.4
Arts, entertainment and recreation, other service activities and activities of households as employers;	-0.4	0.0
Gross value added (GVA)	-0.4	-0.3
Net taxes	-0.5	-0.1

Sources: SORS and NBS calculation.

construction works, rising production of construction material and an increase in the number of employees in the construction sector. Broken down by quarter, after falling in Q1 (3.8% s-a), the sector recovered in Q2 (5.8% s-a), which may be associated with improved regulations relating to the issuance of construction permits and stepped up capital investments of the government.

Estimated to have declined by around 10% y-o-y, agricultural production provided a negative contribution to GDP in H1. A similar drop is expected at the year-level given the unfavourable weather in July (reflecting on autumn yields – corn and industrial plants) and the high base resulting from good last year's season.

In H1, economic activity contracted in the majority of service sectors by 0.7% in aggregate terms. Consistent with expectations, activity in service sectors with a significant government share (public administration, education, healthcare and social welfare) was lower in H1 compared to the same period last year. Still, positive trends were observed in individual sectors (a moderate rise in retail trade turnover, rising physical volume of services in the transportation sector, a higher number of tourist overnight stays).

Along with further growth in industry and construction, positive trends in some service sectors should help step up growth in H2 – at the year-level, GDP growth is expected at around 0.5%.

8. Wages and employment

Real net wages declined in Q1 primarily on account of fiscal consolidation measures, which is indicated by the stronger fall in the public than in the private sector. Wages recovered gradually in Q2, driven by the growth in private sector wages, whereas real net wages in the public sector stagnated. In semi-annual terms, real net wages were lower in H1 2015 than in H2 2014. The decline was however more notable in the public (6.8% s-a) than in the private sector (2.4% s-a), whereas year-on-year, real net wages in H1 this year were 0.6% higher in the private sector and 7.9% lower in the public sector.

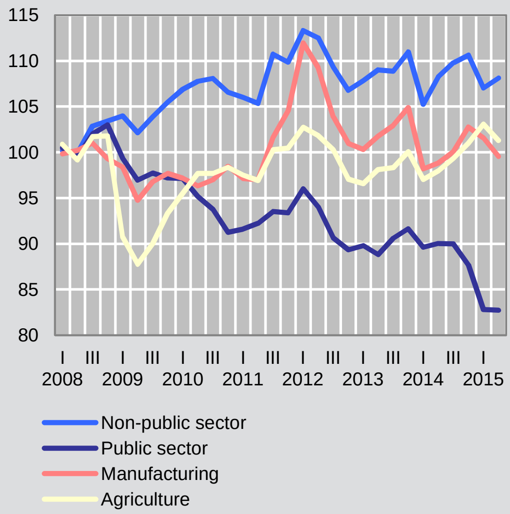
By activity, the strongest y-o-y growth in real net wages was recorded in construction and professional, innovation and technical activities, while there was a slight wage increase in manufacturing, agriculture, information and communications, and accommodation and food services. On the other hand, predominantly government-related activities (public administration, education, health and social protection) recorded the greatest drop in real net wages. Also on the decline were real net wages in the sectors of electricity, gas and steam supply, mining and transport.

Real net wage bill fell by 3.5% s-a in H1 relative to H2 2014, while the decline was smaller in y-o-y terms (1.0%). As in the case of average wages, the falling trend was driven by the contraction in the public sector, while the real net wage bill in the private sector expanded by 2.6% y-o-y. This led to the narrowing of the gap between public and private sector wages. As a result, average nominal net wage was 8.5% higher in the public sector (46,512 dinars) than in the private sector (42,900 dinars), which is by around 10 pp less than in H1 2014.

Unit labour costs of the total industry increased by 1.5% y-o-y in H1, as productivity grew less than gross real wages. The increase in unit labour costs was more pronounced within the manufacturing sector.

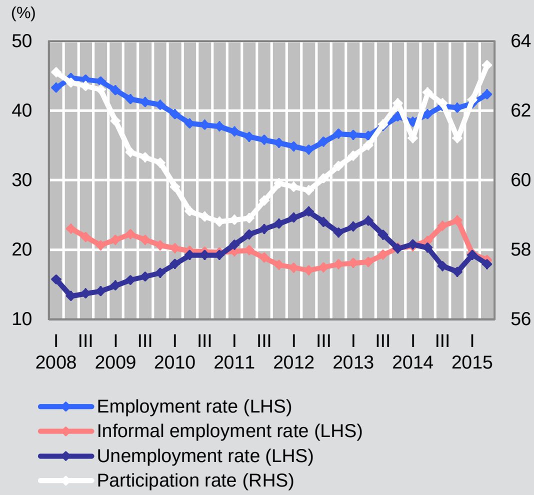
According to the Labour Force Survey, H1 was marked by positive labour market movements. The employment

Chart III.8.1 **Real net wages**
(s-a)



Sources: SORS and NBS calculation.

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



Source: SORS.

rate picked up by 1.9 pp to 42.3%, supported by the higher participation rate (by 2.1 pp to 63.3%). It should be noted that the overall rise in employment was recorded in the formal sector, since in H1 informal employment declined by 5.6 pp (to 18.5% in Q2), which in part can be explained by more intensive inspections and fighting against grey economy. Since the beginning of the year, the unemployment rate rose somewhat (by 1.1 pp to 17.9% in Q2), but still posted a 2.4 pp decline relative to Q2 2014.

The rise in employment in H1 was driven by a higher number of persons employed with legal entities and full-time employees, while the number of self-employed workers, family workers and employees with less than full-time working hours, declined. By sector, employment expanded the most in trade, accommodation and food services, and manufacturing, while the number of employees dropped in agriculture, construction, and electricity, gas and steam supply.

According to the Serbian Statistical Office, formal employment fell by 4,325 in H1, more notably in the public than in the private sector. The number of independent entrepreneurs declined considerably more (by 3,205) than the number of persons employed with legal entities (1,120). Broken down by activity, employment went down the most in sectors of health and social protection, state administration and the financial sector. Employment also fell in agriculture, construction, trade and transport. On the other hand, high increase in employment was recorded in accommodation and food

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

	2014		2015	
	Q3	Q4	Q1	Q2
Formal employment	**1,704.9**	**1,718.8**	**1,716.1**	**1,714.5**
Farmers	**454.2**	**450.5**	**434.3**	**410.8**
Total employment	**2,159.1**	**2,169.3**	**2,150.4**	**2,125.3**
Total unemployment	**748.5**	**741.9**	**766.5**	**746.0**
First-time job seekers	261.4	256.3	259.5	252.5
Workers with previous job experience	487.2	485.6	507.0	493.5

Sources: SORS and National Employment Service.

services and administrative and support service activities, which may be due to more intensive inspections, since informal employment in these sectors was rather high. Employment also rose in the sector of industry (by 218), with employment in manufacturing going up and the number of employees in mining, electricity, gas and steam supply going down.

As suggested by the National Employment Service, the unemployment figure was up by 4,104 in H1. The increase related entirely to the formerly employed persons, while the number of first-time job seekers went down. In H1, the number of unemployment beneficiaries fell to 51,520 in June.

9. Inflation expectations

Owing to a long spell of low inflation and expected weak inflationary pressures, short- and mid-term inflation expectations continued within the target tolerance band in H1. Stable inflation expectations are a key prerequisite to inflation stabilisation and increased effectiveness of the monetary policy measures.

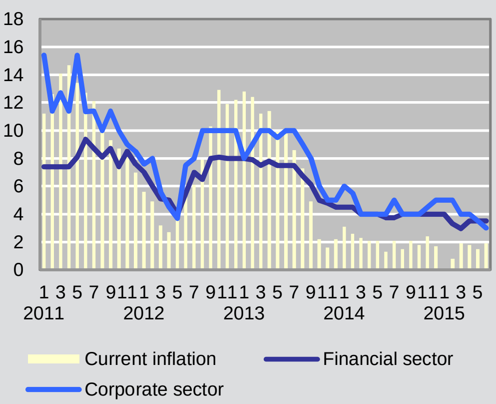
Having moved within the target tolerance band throughout 2014, inflation expectations of the financial and corporate sectors were additionally lowered in H1. According to the **Bloomberg survey**, the financial sector expected **one-year ahead inflation** to be on target (4%) for almost the entire H1, save in January (4.5%). Inflation expectations of the financial sector have been moving within the target tolerance band for nearly two years. **Ninamedia**[28] **survey** indicates that, from early 2015 to March, inflation expectations of the financial sector were lowered from 4.0% to 3.0%, only to stabilise at 3.5% in the April-June period. Corporate inflation expectations have been on a constant decline since the beginning of the year, hitting their lowest in June (3%). Inflation expectations of corporates have been moving within the target tolerance band since February 2014.

After reaching 8% in January, one-year ahead inflation expectations of the household sector stabilised at 5.0% and kept at that level until end-H1, inching up only in May (5.4%), but coming down to 5.0% already in June. As regards qualitative inflation expectations of households, the number of respondents anticipating prices to either rise moderately or increase somewhat in the coming year has picked up (around two thirds of respondents), whereas the number of those expecting considerable increase in prices has declined (15.0%). The number of responses expecting prices to remain unchanged (12.0%) or fall (4.0%) still represents a significant share.

Mid-term inflation expectations recorded favourable trends across all sectors in H1. The financial sector expected **two-year ahead inflation** to be on target, and even slightly lower in February and March (3.9% and 3.7% respectively). In Q1, corporates expected two-year ahead inflation to measure 5.0%, lowering their expectations to 4.0% in Q2. After the January 8%, mid-term inflation expectations of the household sector have continued moving within the target tolerance band.

During H1, both Bloomberg and Ninamedia surveys reported relatively unchanged dispersion of responses in the financial sector, which traditionally shows smallest

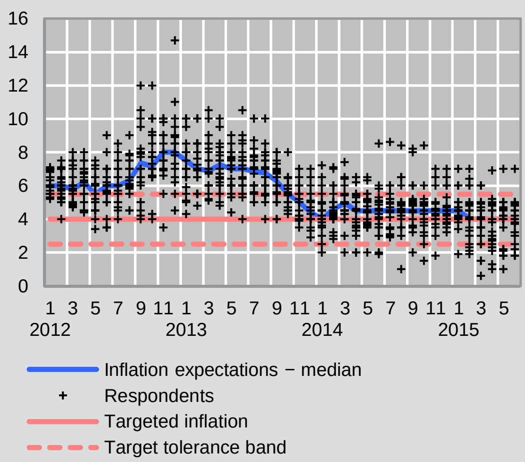
Chart III.9.1 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, %)



Sources: Gallup, Ipsos, Ninamedia and NBS.

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

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



Sources: Bloomberg and NBS.

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

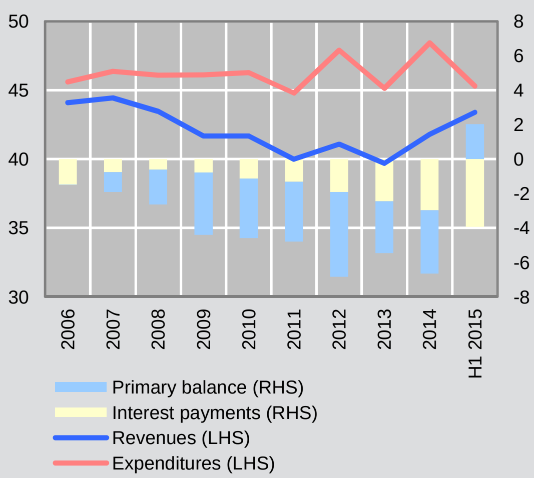
disagreement between respondents. At the same time, the dispersion of corporate and household responses continued narrowing further.

10. Fiscal policy

Fiscal consolidation measures adopted last year resulted in highly favourable fiscal developments in H1. The **consolidated budget deficit** narrowed by almost 70% to RSD 35.3 bln (or 1.9% of GDP) y-o-y, which is much below the ceiling envisaged by the arrangement with the IMF (RSD 96.3 bln). Moreover, excluding interest expenses, H1 saw a primary budget surplus of 2.0% of GDP. In addition, the first review of the arrangement with the IMF, relating to public finance until end-Q1, was completed in June.

Consolidated revenue amounted to RSD 805.2 bln in H1, up by 5.1% in real y-o-y terms. Non-tax revenue and grants (53.8% and 41.2%) recorded real growth, while tax revenue stagnated in real terms. Still, within tax revenue, a significant contribution to growth in total government revenue originated from VAT and excises on tobacco products, reflecting the efforts to curb the grey economy. Namely, the fiscal consolidation programme sets the struggle against the grey economy and tax evasion as a priority on the revenue side of the budget. By contrast, corporate income tax receipts fell by 15.3% in real terms relative to H1 2014, which may be associated with lower accounting profit in 2014.

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



Sources: Ministry of Finance and NBS.

Consolidated expenditure equalled RSD 840.5 bln in H1, down by 4.6% in real y-o-y terms. In line with the fiscal consolidation programme, the main driver behind the decline were outlays for public sector wages and pensions (down by 12.1% and 4.5% respectively) and cuts in budgetary loans (by 87.9%). A real decline relative to H1 2014 was observed for capital expenditure (13.7%), subsidies (2.6%) and outlays for the purchase of goods and services (0.8%). Working in the opposite direction were payments for interest, social protection and called guarantees (up by 12.7%, 6.1% and 58.3%, respectively).

Given the fiscal trends in H1, the annual budget deficit is estimated at around 4.0% of GDP, down by around 2.5 pp from 2014.

Government borrowing in the domestic market was the **main source of budget deficit funding** in H1. However, owing to favourable fiscal trends and a significantly lower deficit than planned, government borrowing was slow. Government debt based on dinar securities issued in the domestic market increased by RSD 41.0 bln (to RSD 591.6 bln), and debt based on euro securities was up EUR 253.7 mln (to EUR 2.1 bln) – the bulk of the increase was recorded in the first four months of the year.

Total central government debt was up EUR 1.0 bln to EUR 23.8 bln in late June.[29] The share of this debt in GDP rose by 2.6 pp to 73.6%. Still, the increase may be largely attributable to strengthening of the US dollar against the euro (c. 8% in H1) and a high share of dollar debt in total public debt (33.1%). Given that fiscal consolidation and narrowing of the budget deficit diminish the government's need to borrow, the main risk associated with public debt movements is potential further appreciation of the US dollar.

Continued consistent implementation of fiscal consolidation measures and structural reforms is necessary not only for the sake of ensuring sound public finance, but also in order to improve conditions for private sector borrowing, enhance external competitiveness and create preconditions for sustainable economic growth.

[29] At end-H1, general government public debt stood at EUR 24.2 bln or 74.9% of GDP, which indicates its further growth above the statutory limit of 45%.

Appendix 1. National Bank of Serbia's Memorandum on Inflation Targets until 2018

National Bank of Serbia's
Memorandum on Inflation Targets until 2018[1]

To define the framework for medium-term monetary policy decision making and to anchor and stabilise inflation expectations, the Executive Board of the National Bank of Serbia hereby sets the inflation target for the years 2017 and 2018.

In line with the *Agreement between the National Bank of Serbia and the Government of the Republic of Serbia on Inflation Targeting*[2] and the *Memorandum of the National Bank of Serbia on Monetary Strategy*[3], pursuant to which the National Bank of Serbia has committed to set inflation targets in cooperation with the Government, the Executive Board of the National Bank of Serbia hereby sets **the headline inflation target (with a tolerance band), measured as an annual percentage change in the consumer price index**, for the period January 2017–December 2018 at the level of 4% with a tolerance band of ±1.5 percentage points. The earlier defined inflation targets for 2015 and 2016 have not been changed.[4]

The trajectory of targeted inflation reflects the intention to achieve price stability without causing macroeconomic disruptions. The inflation targets for 2017 and 2018 are set above the quantitative definition of price stability and inflation targets of advanced economies (2.0% or 2.5%) due to the assessment that the process of structural reforms and the liberalisation of prices, i.e. nominal, real and structural convergence to the European Union, will not be completed by 2018.

It should be borne in mind that the inflation target is a medium-term objective, i.e. that the actual inflation may temporarily deviate from the target due to exogenous shocks. The National Bank of Serbia will allow temporary deviations from the target if bringing inflation back to the target in the short term warrants monetary changes that would cause additional macroeconomic disruptions. This applies to sudden changes in primary commodity prices or to deviations of the planned growth in product prices under the Government's direct or indirect regulation. In cooperation with the Government, the National Bank of Serbia may change the targets set for inflation. Such changes will be made in exceptional circumstances only and will be explained by the National Bank of Serbia.

[1] Adopted at the NBS Executive Board meeting of 13 August 2015.
[2] Adopted at the Government session of 19 December 2008.
[3] Adopted at the NBS Monetary Policy Committee meeting of 22 December 2008
[4] See the National Bank of Serbia's Memorandum on Inflation Targets until 2016.

Appendix 2. National Bank of Serbia's Letter to the Government of the Republic of Serbia on Reasons Why Inflation Departed from the Target from September 2014 to February 2015

Belgrade, 19 March 2015

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

In accordance with the Agreement on Inflation Targeting Between the National Bank of Serbia and the Government of the Republic of Serbia (Section 6, paragraph 4), I am writing this letter to inform you that y-o-y consumer price growth equalled 0.8% in February, which was the sixth consecutive month of inflation moving below the lower bound of the target tolerance band (4.0±1.5%), after the letter we had sent in September 2014 in order to explain the reasons for the undershooting. This letter explains why inflation has moved away from the target tolerance band, describes the measures that will be taken with a view to bringing back and maintaining inflation within the target tolerance band in the medium term, and sets out the period within which we expect inflation to return within the band.

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

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

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

The National Bank of Serbia has taken measures within its remit to bring inflation back within the target tolerance band in the medium run. Monetary policy easing started back in May 2013. Since then, the key policy rate has been cut from 11.75% to 7.5%, while the weighted average rate on one-week repo operations of the National Bank of Serbia has been moving around 6%. Furthermore, to encourage credit activity and, indirectly, economic activity, the rate of FX required reserve allocations was cut in November, December and January.

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

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

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

Yours sincerely,

Dr Jorgovanka Tabaković

Submitted to:

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

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