National Bank of Serbia

2019

January-June

SEMI-ANNUAL

MONETARY POLICY REPORT

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

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

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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 of the year under review.[1]

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

The *Semi-Annual Monetary Policy Report, January–June 2019* was reviewed and adopted by the NBS Executive Board at its meeting of 12 September 2019.

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

Željko Jović, Vice Governor

Ana Ivković, Vice Governor

Dragana Stanić, Vice Governor

[1] Law on the National Bank of Serbia (RS Official Gazette, Nos 72/2003, 55/2004, 85/2005 – other law, 44/2010, 76/2012, 106/2012, 14/2015 – CC decision and 44/2018.

[2] RS Official Gazette, Nos 12/2013, 18/2015, 72/2015 and 50/2018.

ABBREVIATIONS

bn – billion
bp – basis point
CEFTA – Central European Free Trade Agreement
CPI – Consumer Price Index
ECB – European Central Bank
EMBI – Emerging Markets Bond Index
FAO – Food and Agriculture Organization
FDI – foreign direct investment
Fed – Federal Reserve System
FOMC – Federal Open Market Committee
GDP – Gross Domestic Product
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
mn – million
NPL – non-performing loan
OPEC – Organization of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
q-o-q – quarter-on-quarter
s-a – seasonally-adjusted
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

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Overview

The NBS continued running a responsible monetary policy in the period under review, i.e. in accordance with inflation projections and the expected movement of other macroeconomic indicators in the domestic and international environment. **After being kept on hold (3.0%) in the first half of the year, the key policy rate was trimmed by 25 bp in both July and August, to its lowest level in the inflation targeting regime (2.5%)**.

The NBS Executive Board kept the key policy rate unchanged in H1 in view of the positive impact of domestic macroeconomic conditions on economic activity and inflation, and developments in the international environment which mandated caution in the conduct of monetary policy. Since the start of the year the Executive Board has stressed repeatedly that **growing protectionism in international trade** could have an adverse impact on financial and commodity markets, through **uncertainty as to the pace of global growth and inflation, USD/EUR exchange rate and capital flows to emerging markets**. Though the Fed and the ECB signalled that the pace of normalisation of their monetary policies could be slower than anticipated earlier, it remained uncertain to what extent it would differ from market expectations, which could lead to volatility in capital flows to emerging market economies. **Caution** in monetary policy decision-making was also warranted by the **global prices of primary commodities, notably oil**, which fluctuated in H1 from USD 53 to USD 74 per barrel under the impact of numerous factors on both supply and demand side.

Trade tensions were particularly heightened in May and early June, which raised concerns over their negative impact on confidence, investment and economic growth. While the IMF and other relevant international institutions scaled down their forecasts of global growth, the NBS paid special attention to the forecasts relating to Serbia's key trade partners, above all the euro area, which was poised for slower growth, as well as regional peers, which faced a somewhat better outlook owing to domestic demand.

Mounting certainty that leading central banks would increase their monetary accomodation, and persistently low inflationary pressures in the domestic market on account of the majority of internal and external factors enabled **the NBS to ease its monetary policy stance further by cutting the key policy rate in July and August by 25 bp each, to the level of 2.5%, and thus provide additional support to credit and economic growth**.

As in the prior period, favourable macroeconomic conditions of monetary policy implementation since the start of the year were reflected mainly in the fact that **inflation was kept firmly under control for the sixth year in a row**. In line with the Executive Board announcements, after reaching the target midpoint in April, y-o-y inflation moved in the lower part of the target tolerance band, largely under the sway of vegetable prices, which in the first four months, as in other countries of the region, soared due to weak crops, but then receded once the new season set in. **It was expected that inflation would continue to move within the target band in the coming period – most probably in the lower part of the band**. Subdued inflationary pressures were indicated also by the persistently low and stable core inflation and by the fact that both short- and medium-term inflation expectations of the financial and corporate sectors were anchored around the inflation target of the NBS.

Led primarily by the **gradually increasing domestic demand**, inflation should approach the target midpoint in the medium term. The increase in domestic demand is supported, through the growth in credit activity and disposable income of households, by the **lower interest**

rates on new dinar loans. From end-2018 to June 2019 these rates were cut by 0.6 pp, to 5.1% for corporates and 9.75% for households. Thus, **interest rates on new dinar loans to households plunged to their lowest level in the inflation targeting regime**. Also, interest rates on euro loans remained low, underpinned by the persistently accomodative monetary policy of the ECB, and by the greater interbank competition and Serbia's lower risk premium.

Serbia's risk premium is among the lowest in the region – in H1 2019 it fell by 70 bp, to 89 bp, only to **plunge further in July to below 60 bp, its lowest level on record**. The fall in the country risk premium was aided not only by global factors, but also those domestic, which shows that investors judge Serbia's macroeconomic prospects to be favourable. **A positive signal to investors is also sent by rating agencies**, which affirmed Serbia's stable/positive outlook in H1, citing as the underlying factors, inter alia, **increased credibility of the NBS's monetary policy and the preserved price and financial stability**.

Lower price of borrowing in the domestic market, along with economic growth and labour market recovery, supported **further credit growth**, which amounted to 9.4% y-o-y in June. Together with continuing NPL resolution activities, credit growth contributed to a **further reduction in the share of NPLs in total loans to its new low: 5.2% in June**, down by 17.2 pp since the adoption of the NPL Resolution Strategy. The share of NPLs in total loans was cut additionally in July, to 4.98%.

Domestic drivers of economic growth offset the negative impact of external factors. Owing to a sustainable rise in domestic demand – household consumption and investment – in H1 2019 GDP grew 2.8% y-o-y. **Household consumption** is encouraged primarily by the growth in wages and employment and lower credit expenses, and **investment** by the improved business environment, continued implementation of infrastructure projects and favourable sources of financing for the private sector. On the other hand, net exports provided a negative contribution to GDP in H1. On the production side, GDP growth in H1 2019 was led mainly by the **upswing in construction and service sectors**, on the back of intensive implementation of infrastructure projects and the recovery of domestic demand. In addition to continuing growth in services sectors and construction, we expect that industrial production will bounce back until the end of the year and prop up GDP growth to 3.5% in 2019. As in H1, on the expenditure side, growth will be led by domestic demand, but also by the somewhat faster export growth on account of better export supply resulting from prior investments. In the medium term, assuming persistent positive effects of the said factors and further implementation of reforms, GDP growth is expected to step up to around 4%.

Despite slackening external demand, export growth stayed relatively high, benefiting from new production capacities and the sale of agricultural commodity stocks from the previous season. **Driven by intermediate goods and equipment, the import of goods increased somewhat faster than the export**. In conditions of rising consumer demand, the import of consumer goods picked up as well. Overall in 2019, the share of the current account deficit in GDP should be similar to last year's, while in the medium run it is expected to go further down, given the sustained high inflow of FDI channeled to tradable sectors. **In the coming years too, the current account deficit should be more than covered by FDI inflows**, which will have a positive effect on the sustainability of Serbia's external position.

Among the highest in the region, FDI remains project-diversified and directed mainly into tradable sectors, which will **provide for the further expansion of export base in the period ahead**. A low and stable inflation and relatively stable exchange rate, together with improved business conditions, contributed to **the FDI inflow of EUR 1.9 bn or 9.0% of the estimated GDP in H1**. In addition, foreign investors stepped up their investment into dinar government securities, and Serbia secured a more favourable treatment and financial conditions in the international financial market. This is best illustrated by the fact that **the government managed to substitute a portion of expensive dollar debt by much cheaper financing in euros at end-June**, selling eurobonds in the nominal amount of EUR 1 bn, at the rate of 1.619% (1.5% coupon rate). **This is the lowest interest rate Serbia has ever had in the international market and, at the same time, among the lowest rates on ten-year eurobonds issued in euros by countries in the region**, even those having a higher credit rating than Serbia.

Increased investment of foreign investors in Serbia contributed to the strengthening of appreciation pressures in the local FX market. After moderate depreciation pressures in January, conditioned primarily by the seasonally higher FX demand of energy importers, as of February the FX market saw a renewal of appreciation pressures, which prevailed over the past two and a half years. In order to ease excessive short-term volatility of the exchange rate of the dinar vis-à-vis the euro, the NBS intervened in the IFEM in H1 by buying

EUR 955.0 mn net. This provided a major contribution to the **growth in NBS FX reserves, which increased in H1 to their highest gross and net levels since 2000**, when these data began to be monitored. At end-June 2019, gross FX reserves amounted to EUR 12,146 mn, up by EUR 884 mn from end-2018. **The level of Serbia's FX reserves remains adequate and ensures protection from external shocks**, since it covers M1 by 185% and over five months' worth of the import of goods and services. At the same time, net FX reserves came at EUR 10,142 mn, up by EUR 1,288 mn from end-2018.

The overall macroeconomic stability and development prospects of our country were also underpinned by the positive fiscal trends, **reflected in a consolidated budget surplus of 0.7% of GDP in H1 and a fall in the public debt-to-GDP ratio to 51.4% in June**. **Excluding interest expenses, the primary surplus measured 3.4% of GDP**. Such fiscal result was supported by the real 5.1% y-o-y growth in consolidated revenue, driven by VAT receipts, higher social insurance contributions, as well as receipts from income tax amid continued positive trends in the labour market. At the same time, consolidated expenditure went up in real terms by 7.1% y-o-y, spurred primarily by the faster rise in capital expenditure (up by 27.2% in real terms). Increased expenditure is also attributable to higher pensions and public sector wages and, to a slightly smaller degree, to the rising outlays for the purchase of goods and services and interest expenses. Positive trends are further confirmed by the **increased share of public debt in dinars (from 26.0% in late 2018 to 27.0% in June 2019), which helps reduce the currency risk**. The deficit planned for this year is 0.5% of GDP. At the same time, this is the medium-term deficit target that will maintain the share of public debt in GDP on a downward path in the years to come, reflecting positively on the country risk premium and credit rating.

Favourable macroeconomic developments translated into positive labour market trends which have not been interrupted since mid-2014. Thus, **total nominal net wage recorded almost two-digit growth in H1** (9.8% y-o-y), rising at a faster pace in the private (10.5%) than in the public sector (9.4%). Another positive aspect is that the **increase in net nominal wages was registered across all economic sectors**. At the same time, **the number of the unemployed fell to its lowest level since comparable data are available**. Similar tendencies are suggested by the results of the Labour Force Survey for Q2 2019, according to which employment rate rose relative to the same period a year earlier, while **unemployment rate fell to 10.3% and long-term unemployment rate to 6.1%, these being their lowest levels on record**. Particularly important is the decrease in the youth unemployment rate. **Looking ahead, favourable labour market trends are expected to be sustained**, and so are economic growth and the positive operating results of companies in the majority of economic sectors.

Monetary and economic developments recorded in Serbia since the beginning of the year represent a sound basis for the continuation of sustainable and vibrant economic growth in the coming period. As so far, **the NBS will maintain medium-term inflation low and stable and preserve stability of the financial system, fulfilling its tasks successfully and contributing to the country's economic prosperity**.

I Strategic monetary policy framework

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

The inflation targeting regime is pursued by a large number of central banks worldwide as a pragmatic response to the deficiencies of other monetary policy regimes. The choice of the regime was strengthened by the awareness that high inflation rates dampen economic growth and employment and that the monetary policy focus should therefore be shifted from short-term demand management to medium-term price stability which lies at the core of inflation targeting. 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 NBS inflation target is defined in terms of the headline inflation rate (with a tolerance band) measured as the annual percentage change in the Consumer Price Index (CPI). In order to define the framework for medium-term monetary policy decision-making and to anchor and stabilise inflation expectations, the decision on the level of the inflation target is always made for the period ahead. In the case of Serbia, this decision is made for three years ahead and this will remain so until the process of nominal, real and structural convergence to the EU is completed. As the process is ongoing, the inflation target is slightly above the level of the quantitative definition of price stability and the level of the inflation target in advanced economies (2.0% or 2.5%). In late 2018, **the inflation target for the period January 2019–December 2021 was set at 3%, with a tolerance band of 1.5 pp**.[2]

For the sake of reminder, as of 2017 the inflation target has been lowered by 1 pp to 3.0±1.5%[3], confirming the economic policy makers' determination to keep medium-term inflation low, stable and predictable. In cooperation with the Government, the NBS made such decision owing to the achieved and maintained low and stable inflation, for three consecutive years at the time, significantly improved macroeconomic fundamentals and prospects for our economy, which reflected successful coordination of monetary and fiscal policies and excellent results of fiscal consolidation. Inflation expectations of the financial and corporate sectors for both one and two years ahead were low and relatively stable for quite some time, testifying to increased credibility of the NBS monetary policy.

The width of the target tolerance band has been kept at ±1.5 pp, to diminish the need for frequent monetary policy interventions and contribute to higher predictability of monetary conditions. Being a small and open economy, Serbia is exposed to developments in the international commodity and financial markets, which may cause

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

[2] The National Bank of Serbia's Memorandum on Inflation Targets until 2021 was adopted at the meeting of the NBS Executive Board of 6 December 2018.

[3] The National Bank of Serbia's Memorandum on Inflation Targets until 2018.

temporary volatility of headline inflation. The target tolerance band leaves to the NBS more room to work on the achievement of its second objective – financial stability, and to support the Government's economic policy which encourages sustainable economic growth.

It should be borne in mind that the inflation target is a medium-term objective, i.e. that the inflation outturn may diverge from the target in the short run due to exogenous shocks. The NBS 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 disruptions to macroeconomic processes. This also applies to sudden shocks in primary commodity prices or deviations from the planned growth in commodity prices under direct or indirect government regulation.

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

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

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

II Monetary policy and achievement of the inflation target

1 Monetary policy since early 2019

In H1 2019, monetary policy was pursued in accordance with the **Monetary Policy Programme of the National Bank of Serbia in 2019**.[4] As envisaged by the Programme, the NBS seeks to achieve the inflation target through consistent and predictable changes in the key policy rate, taking into account the inflation projection, economic developments in the domestic and international environment, and the impact of these changes on financial stability. As highlighted in the Programme, the vigorous fiscal adjustment, implementation of structural reforms and full coordination of monetary and fiscal policy measures helped strengthen macroeconomic stability and increase the resilience of the domestic economy to potentially adverse effects from the international environment, making the economic outlook more favourable. In 2019, the National Bank of Serbia will continue to maintain the necessary caution in adopting monetary policy decisions, bearing in mind uncertainties from the international environment.

The key policy rate, as the main monetary policy instrument of the NBS, **was kept in H1 2019 unchanged at 3.0%**, which at the time was the lowest level in the inflation targeting regime. The NBS Executive Board had in mind that the domestic macroeconomic conditions positively affected economic activity and inflation, while international developments warranted caution in the conduct of monetary policy.

Inflationary pressures in Serbia remained low both on the cost- and demand-side. In accordance with the announcements of the Executive Board, after reaching 3.1% in April, which is its this year's maximum, until late June y-o-y inflation moved within the lower part of the target band, with inflation projections suggesting that it will continue to move in this part of the band until the end of the projection horizon. That inflationary pressures were low was also indicated by core inflation, which in H1 moved within the 1.2–1.5% range y-o-y, and inflation expectations of the financial and corporate sectors, anchored around the 3.0% target both for one and two years ahead.

As assessed by the Executive Board, in the medium term inflation would approach the target owing to the **further rise in domestic demand**. The Executive Board emphasised that positive labour market trends and rising public sector wages and pensions, through a positive impact on household disposable income, supported a further rise in domestic demand. A positive impetus to disposable income was also coming from lower interest rates and subsequently lower loan repayment costs, achieved owing to past NBS monetary policy easing. In addition, the achieved and maintained financial stability and relative stability of the domestic currency, along with the lowest on record share of NPLs in total loans, open room for the continuation of lending and economic growth. A positive effect also originates from low interest rates on euro-indexed loans, which should remain low for a longer period than initially expected, given the announcements of leading central banks to slow the process of normalisation of their monetary policies and offer additional monetary stimuli. Low interest rates will also be supported by the low country risk premium and increased interbank competition.

[4] RS Official Gazette, No 96/2018.

The country's overall macroeconomic stability and development prospects were also underpinned by **positive fiscal movements**. Budget at the consolidated level has been in a surplus since the start of the year, and the share of public debt in GDP continued to decline. According to the Fiscal Strategy for 2019, the fiscal policy stance in the coming period is likely to be mildly accommodative, without major upward pressures on inflation. Expansion in government capital expenditure will boost investment, while rising public sector wages and pensions will pave the way for sustainable consumption growth. The deficit of 0.5% of GDP is planned for this year, which is a medium-term deficit target, ensuring a continued downward path of the public debt share in GDP in the coming years. This should continue to positively affect the country risk premium and credit rating.

The share of external debt in GDP also declined, which together with the high FDI inflow contributes to the sustainability of the country's external position. **Stable and low inflation and a relatively stable exchange rate contributed to a rising FDI inflow, which is among the highest in the region**. In addition, non-resident investment in dinar government securities increased, fuelling further appreciation pressures in the FX market in H1 2019 as well. The Executive Board assessed that the reduced internal and external imbalances and favourable macroeconomic prospects of **Serbia are of the key importance for more favourable treatment and financial conditions the country may obtain in the financial market**. This is best confirmed by the fact that in late June Serbia managed to replace a portion of the expensive dollar debt for much cheaper financing in euros, selling eurobonds in the nominal amount of EUR 1 bn at a rate of 1.619% (coupon rate of 1.5%). This rate is the lowest rate that Serbia has ever achieved in the international environment and among the lowest rates on ten-year eurobonds in euros issued by countries in the region, including even those with a rating higher than Serbia's.

FDIs continued to fully cover the current account deficit, which remained under the impact of rising investment in the country and softer external demand. However, despite the slowdown in external demand, export growth remained relatively high owing to new production capacities and the placement of agricultural inventories from the previous season. Goods imports grew somewhat faster than exports and, as in the previous period, were driven by higher imports of intermediate goods and equipment. Against the background of rising consumer demand, the imports of consumer goods were also on the rise. At the year-level, the Executive Board assessed that the share of the current account deficit in GDP would be similar to last year's and probably decline further in the medium run, bearing in mind primarily the continuation of a high inflow of FDI channelled to tradeable sectors. The Executive Board emphasised that the current account deficit would be more than fully covered by the FDI inflow in the coming years, continuing to contribute to relative stability in the FX market.

Unlike favourable macroeconomic conditions at home, factors from the international environment mandated caution in the conduct of monetary policy. **Caution was needed primarily due to trade tensions among leading world economies**, which not only worsened the global growth outlook, through investors' poorer risk appetite, but also increased uncertainty in the international commodity and financial markets. The Executive Board expected further recovery of external demand, but pointed out that the slowdown in global trade and economic growth could be stronger than initially expected. The world economy has decelerated since Q3 2018, more than initially projected, amid rising uncertainties fuelled primarily by trade tensions between the US and China, and recession in some emerging markets (Argentina and Turkey). The Executive Board analysed in particular the growth outlook of the euro area, our most important trade partner which, among other things, faces Brexit challenges. Significantly slower growth was expected in the short term due to the global growth softening and factors specific for some sectors and countries of the euro area, while favourable terms of financing, further improvement in the labour market, a decrease in unemployment and rising wages were expected to support a gradual pick-up in the medium term. On the other hand, albeit softened, economic growth remains vibrant in the majority of Central and Southeastern European countries, which are also our important trade partners. This is owing to domestic demand, which continued to drive economic growth, while a negative contribution originated from net exports, reflecting the slowdown in external demand.

In making decisions on monetary policy, since the start of the year, the Executive Board emphasized that growing protectionism in international trade could negatively affect financial and commodity markets, through **uncertainties as to the pace of normalisation of monetary policies of leading central banks, the dollar-euro relationship and capital flows to emerging economies**. Tensions were especially tightened in May and early June, primarily due to the introduction of new tariffs by the USA on imports from China and the announcement of new tariffs on imports from Mexico. New protectionist measures and trade tensions continued to jeopardise business confidence, increasing concerns that it could reflect negatively on investment and economic growth.

In the context of rising uncertainty over global growth prospects, the leading central banks gradually changed their rhetoric on future monetary policy. After raising the fed funds rate in December last year, the Fed first announced caution as to changes in monetary policy, consistent with movements in economic indicators, only to face by late June the dilemma of whether to keep on hold or cut the key policy rate. The ECB announced to extend the period during which it expects no changes in it key rates, and stated in March that it would launch the new, third targeted longer-term refinancing operations (TLTRO III), to be implemented from September 2019 to March 2021, so that banks' lending conditions remain favourable. While the pace of normalisation of monetary policies of leading central banks will be slower than expected, the NBS Executive Board pointed out it was uncertain to what extent it would diverge from market expectations, which could affect capital flows towards emerging markets.

Also, Executive Board decisions on monetary policy called for **caution over the global primary commodity prices, notably of oil**. In H1, global oil prices fluctuated from USD 53 to 74 per barrel. They first rose by almost 40% since the start of the year until mid-May, notably due to further production cuts in OPEC countries, the announcements of Saudi Arabia to limit production so as to reduce inventories, and an unstable situation in Venezuela. Thereafter, as trade and geopolitical tensions increased and the slowdown in the global economy was increasingly certain, oil prices were cut by 13% until the end of June. Although according to futures no significant changes in global oil prices were expected, their movement in the coming period was uncertain due to numerous factors – both on the supply and demand side. Movements in global prices of other primary commodities were also uncertain, primarily in terms of the prices of primary agricultural commodities whose movements spill over onto the prices of domestic agricultural products, which also mandated caution in the conduct of monetary policy.

Having estimated that the key risks in the conduct of monetary policy emanate from the international environment, the Executive Board stressed that trends in the international financial and primary commodity markets, especially markets of crude oil and primary agricultural commodities, will continue to be closely monitored and analysed. The Executive Board pointed out that the resilience of the Serbian economy to potential adverse effects from the international environment has increased, owing to more favourable macroeconomic indicators and prospects.

More and more certain increase in monetary policy accommodation by the leading central banks – the Fed and ECB, against the background of persistently low inflationary pressures in the domestic market based on the majority factors from the domestic and international environment, enabled further monetary policy easing of the NBS in July and August by 25 bp in both months, to 2.5%, which is the new lowest level in the inflation targeting regime. The NBS is thus able to further support lending and economic growth.

The Executive Board will continue to make monetary policy decisions taking into account the effects of past monetary policy easing, and the impacts of other domestic and external factors on inflation. As the key risks to the projection continue to emanate from the international environment, the NBS will continue to closely monitor and analyse movements in the international financial and commodity markets and assess their impact on economic developments in Serbia. As so far, monetary policy will be predictable and consistent in the achievement of low and stable inflation and the preservation of financial and overall macroeconomic stability.

2 Monetary policy instruments

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

Open market operations

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

The NBS implemented repo transactions through own securities. For the needs of repo sale, one series of T-bills issued in late 2018 was used, in the total nominal value of RSD 500 bn. The issuing of one series of T-bills of high nominal value is consistent with the practice in earlier years which enables more adequate management of securities within the same series and facilitates liquidity management for banks.

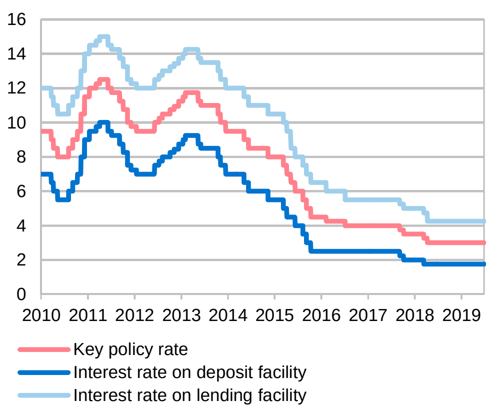
In H1, 26 repo sale auctions were organised. Auctions were organised once a week, **upon the model of the variable multiple interest rate**. The total securities sales amounted to RSD 731.0 bn, which was lower than in H2 2018 (RSD 1,137.7 bn).

The stock of NBS bills in banks' portfolios averaged RSD 27.6 bn in H1, down by RSD 16.7 bn from H2 2018. Relative to end-2018, the stock of these securities increased by RSD 23.5 bn, to RSD 40.0 bn at end-June.

Deposit and lending facilities

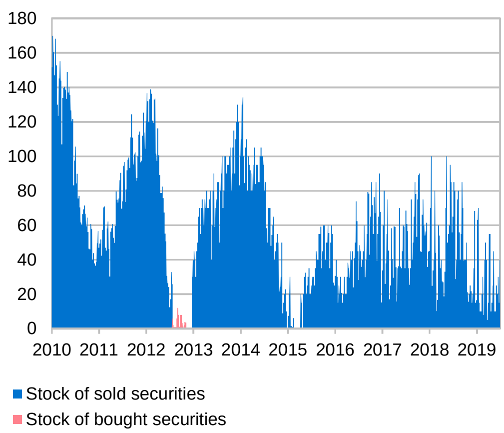
In H1, banks continued to place overnight deposits with the NBS. In the observed period, the average daily stock of such deposits came at RSD 27.9 bn, which is RSD 14.8 bn more than in H2 2018. The highest average monthly stock was recorded in June (RSD 38.5 bn) and the lowest in January (RSD 21.5 bn).

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



Source: NBS.

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



Source: NBS.

In February this year, the NBS adopted amendments to the Decision on the Conditions and Manner of Extending Daily Liquidity Loans to Banks against Collateral of Securities, which regulates NBS lending facilities. Amendments were adopted to ensure necessary preconditions for the efficient settlement of NBS receivables, in accordance with the Law on Financial Collateral, applied as of 1 January 2019. In H1, banks used lending facilities as intraday loans (eight banks). Intraday loans were worth a total of RSD 40.4 bn, with the peak recorded in January (RSD 23.3 bn). Overnight loans were not used.

Required reserves

The Decision on Banks' Required Reserves with the National Bank of Serbia was not changed in H1.

In the observed period, the amount of calculated required reserves allocated in dinars increased by RSD 8.2 bn, standing at RSD 179.4 bn in June. This increase is a result of growth in dinar required reserves (by RSD 3.9 bn) and FX required reserves allocated in dinars (by RSD 4.2 bn).

In the same period, the amount of calculated required reserves allocated in foreign currency increased by EUR 72.0 mn, standing at EUR 1,935.8 mn in June. This was driven by the increase in the FX base by EUR 680.0 mn, which reflects rising FX savings of citizens and FX deposits of corporates.

Interest rates

In H1, the NBS key policy rate was kept on hold at 3.0%. In addition, other interest rates applied by the NBS in the conduct of monetary policy remained unchanged compared to end-2018.

Foreign exchange market operations

Under the 2019 Monetary Policy Programme, the NBS continued implementing the managed float exchange rate regime, with the possibility to intervene in the FX market with a view to easing excessive short-term volatility of the exchange rate, maintaining price and financial stability and an adequate level of FX reserves.

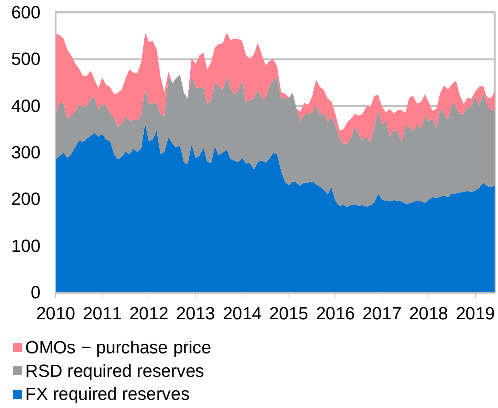
In H1, the dinar gained 0.2% against the euro in nominal terms. Appreciation pressures, in place since April 2017, continued into H1, as a result of the improvement of the country's macroeconomic indicators. Solid macroeconomic indicators and positive prospects of the domestic economy boosted FX inflows from different sources, primarily FDIs, whose net inflow was more than sufficient to cover for the current account deficit. In addition, a high FX inflow came from the increased interest of foreign investors in long-term dinar securities, primarily seven-year benchmark government securities, particularly during Q2. Favourable balance of payments trends, notably a high FDI inflow and accelerated export growth, brought about a better balance between FX supply and demand of domestic enterprises and their elevated FX supply, which was an important factor of relative stability of the FX market in H1.

FX supply in H1 was also influenced by net foreign cash purchases, particularly during holidays, and the increase in net FX-indexed assets as bank lending activity stepped up.[5]

In H1 2018, the NBS intervened in the IFEM as a net buyer of EUR 955.0 mn (selling EUR 130.0 mn in January and buying EUR 1,085.0 mn in the following months). The NBS intervened as a price taker, strictly under market conditions.

At end-Q1, the dinar gained 0.2% against the euro in nominal terms, compared to end-2018. To mitigate excessive short-term volatility of the dinar against the euro, the NBS intervened in the IFEM by buying EUR 35.0 mn net – it bought EUR 165.0 mn and sold EUR 130.0 mn. The NBS sold FX in January, when movements in the FX market were relatively stable, with the emergence of occasional depreciation pressures, notably due to the seasonally higher FX demand of domestic enterprises – energy importers. The nominal weakening of the dinar against the euro equalled 0.2% in January.

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



Source: NBS.

Already as of February, balanced FX demand and supply and non-resident investment in dinar government securities fuelled renewed appreciation pressures, which continued until end-H1.

At end-Q2, the dinar gained 0.1% against the euro in nominal terms, compared to end-Q1. To mitigate excessive short-term volatility of the dinar against the euro, the NBS intervened in the IFEM by buying EUR 920.0 mn, of which EUR 735.0 mn concerns the record purchase in June.

FX swap auctions of the National Bank of Serbia

In H1, the NBS continued to hold its regular three-month and two-week FX swap auctions of FX purchase and sale for dinars, in order to boost the development of interbank swap trading and facilitate more efficient bank liquidity management. During H1, 48 two-week swap auctions were held, with the NBS swap purchasing and selling EUR 312.5 mn each, as well as 50 three-month swap auctions, at which it swap sold and bought EUR 32.0 mn each. The largest performance in H1 was recorded in January, when the NBS swap sold and bought EUR 82.0 mn each. At end-H1, the stock of NBS FX receivables and

[5] Aiming to balance their FX positions, thus reducing exposure to FX risk, banks sell foreign currency, which results in appreciation pressures.

liabilities in respect of three-month and two-week swap auctions equalled EUR 18.0 mn and EUR 25.0 mn, respectively.

Acting proactively in an environment of reduced excess liquidity in the banking sector (particularly in Q1) and with the aim to ensure further unimpeded functioning of the money market and maintenance of relative stability of short-term market interest rates, the NBS organised seven additional FX swap purchase auctions, i.e. it used one of the instruments at its disposal for the regulation of dinar and FX liquidity of the banking sector – FX swap auctions. By organising additional FX swap purchase auctions, in exchange for foreign currency (euros), the NBS provided banks with two-week dinar liquidity in the total amount of RSD 67.0 bn.

3 Achievement of inflation target in the period January–June 2019

In H1 2019, y-o-y inflation continued to move within the target range of 3±1.5%. After approaching the target midpoint (3.1%) in April, as of May y-o-y inflation slowed down and fell to 1.5% in June, which was in line with NBS expectations and announcements. Such movements in y-o-y inflation in H1 were largely determined by vegetable prices, which in the first four months – just like in other countries in the region – recorded vigorous growth in an environment of weak yields. The growth slowed down significantly with the new yields. This is supported by the fact that the contribution of vegetable prices fell from 1.6 pp in March and April to 0.35 pp in June. Apart from this, inflationary pressures both on the demand and cost side remained low. This is confirmed by continuously low and stable core inflation, which in H1 2019 moved around the lower bound of the target band, and stood at 1.4% y-o-y in June. That inflationary pressures are low is also suggested by inflation expectations of the financial and corporate sectors in the short and medium run, which fell below the target midpoint.

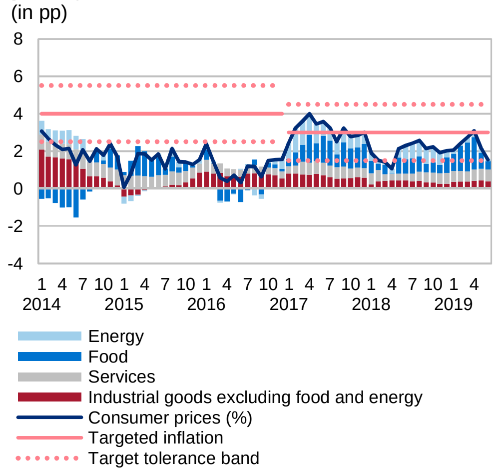
At the level of H1, consumer prices rose by 1.75%, reflecting primarily elevated price growth in Q1 (1.5%), which, similarly to countries in the region, was driven by food price hikes, primarily of unprocessed food, due to the said growth in vegetable prices. H1 saw a rise in fresh meat prices as these prices went up in the EU, as a consequence of rising demand from China. In H1, other

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

	H1 2018	H1 2019	Difference
Consumer prices (CPI)	2.3	1.5	-0.8
Unprocessed food	0.5	0.3	-0.2
Fruit and vegetables	*0.7*	*0.2*	*-0.5*
Fresh meat	*-0.1*	*0.0*	*0.1*
Processed food	0.2	0.2	0.0
Industrial products excluding food and energy	0.4	0.4	0.0
Energy	0.7	0.1	-0.6
Petroleum products	*0.4*	*0.0*	*-0.4*
Services	0.4	0.6	0.2

Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

Table II.3.2 **Growth and contribution of components to consumer price growth in H1 2019**

	Growth rates (%)	Contribution (pp)
Consumer prices (CPI)	**1.75**	**1.75**
Unprocessed food	7.6	0.8
Processed food	0.9	0.2
Industrial products excluding food and energy	0.9	0.3
Energy	1.0	0.2
Services	1.4	0.3
Core inflation indicators		
CPI excluding energy	1.9	1.6
CPI excluding energy and unprocessed food	1.1	0.8
CPI excluding energy, food, alcohol and cigarettes	0.9	0.4
Administered prices	1.1	0.2

Sources: SORS and NBS calculation.

CPI components also gave a positive, though insignificant contribution to inflation. This indicates that the CPI growth was still driven by the increase in the prices of a small number of products and services.

Compared to Q1, when they slightly declined, **prices within core inflation** (measured by CPI excluding the prices of food, energy, alcohol and cigarettes) increased in Q2; at the level of H1, this growth equalled 0.9% (contributing 0.4 pp to inflation). Since early 2019, the increase in these prices was largely determined by the seasonal increase in the prices of travel arrangements. **Administered prices** rose as well – by 1.1% (contributing 0.2 pp to inflation), which is almost fully due to the February cigarette price hike on account of the adjustment of excise prices.

Bearing in mind the projection assumptions, **the NBS stated expectations that in the next two years y-o-y inflation will continue to move within the target band**, most notably in its lower part. Such inflation projection is based on the still low cost-push pressures and sustainable growth in aggregate demand, which is recording a positive trend since end-2014. Uncertainties surrounding the inflation projection are associated primarily with movements in international commodity and financial markets, and administered price growth to an extent. Bearing in mind the analysis of different factors and their impact, the NBS assessed that the risks to the inflation projection are, overall, symmetric until the end of the projection horizon.

III Macroeconomic environment

1 International environment

Economic activity and inflation

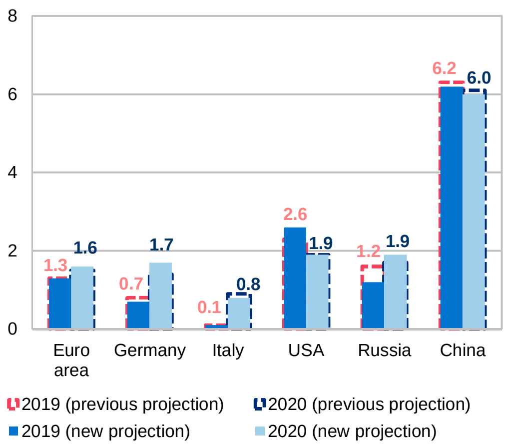
The weaker global growth impulse from H2 2018 transferred into H1 2019 as well. US-China trade tensions still persist, as do the risks of a no-deal Brexit against the backdrop of geopolitical tensions. Though advanced countries recorded economic recovery in Q1, emerging economies did not. Such movements and the uncertainty in the conduct of economic policy reflected on the **slowdown in global trade and investment in H1 2019**. For this reason, leading international institutions agree that risks to the global growth projection remain skewed to the downside. Hence, the IMF made slight downward revisions of its global growth estimates in its July report – by 0.1 pp, to 3.2% in 2019 and 3.5% in 2020.

In contrast to expectations, euro area GDP growth accelerated in Q1 2019 (to 0.4% s-a), driven by investment in fixed assets and private consumption. This was supported by positive developments in the labour market, notably the unemployment rate coming down to its lowest level in 11 years (7.5% in June), as well as the most intensive wage rise in 10 years. At end-2018, economic activity slowed down in Germany and declined in Italy, however, in the first months of 2019 private consumption propped up the rise in Germany's GDP, and production activity gave an impetus to the recovery of the Italian economy. According to the Eurostat's preliminary estimate, economic activity in the euro are slowed down again in Q2 (to 0.2% s-a), as illustrated by leading economic activity indicators. In June, the ECB came out with its forecast of a slower growth pace in the euro area through 2019, due to the impact of a series of external factors, while in the medium term it expects domestic macroeconomic fundamentals, including the ECB's monetary policy accommodation, to continue to provide an impetus to economic growth.

Inflation in the international environment slowed down in H1 2019. Average y-o-y **inflation in the euro area** decelerated at the start of the year – to 1.4% in Q1 2019 – mainly on account of a lower contribution of energy prices, while core inflation equalled 1%, the same as in 2018. According to the ECB, the rise in cost-push pressures amid the high utilisation of capacities and declining unemployment did not translate onto core inflation, because corporates absorbed the higher costs by trimming their profit margins in order to remain competitive. An additional factor contributing to low core inflation was decelerated import inflation in the past two years due to the nominal effective appreciation of the euro. Although average y-o-y inflation in the euro area remained unchanged in Q2, it was more volatile than in Q1. Having reached 1.7% in April, it dropped to 1.2% in May, mainly owing to the lower prices of energy and services, only to edge up to 1.3% in June on the back of the recovery in the prices of services. Average y-o-y core inflation rose mildly, to 1.1% in Q2. In the medium term, the ECB expects a gradual increase in core inflation, supported by monetary policy accommodation and continued, albeit slower economic growth, and rising wages.

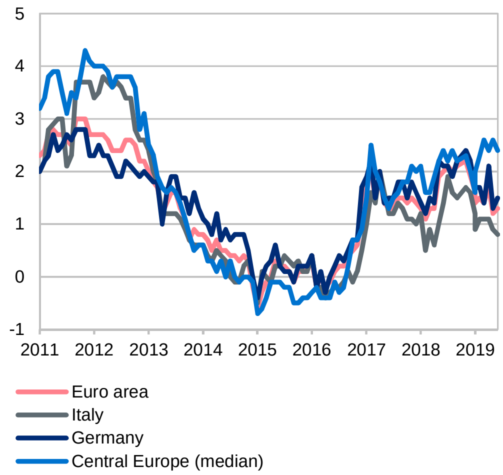
The US economy also accelerated in Q1, to 0.8% s-a, i.e. 3.1% annualised, propped by all components of GDP on the expenditure side. This was followed by a deceleration in US GDP to 2.1% annualised in Q2, with the anticipated weaker investment dynamics until end-2019. The Fed's medium-term projections have not been changed. In addition, the USA boasts extremely favourable labour market trends for quite some time now

Chart III.1.1 **Revisions of real GDP growth forecasts for 2019 and 2020 by the IMF**
(in %)



Sources: IMF WEO (April 2019) and IMF WEO Update (January 2019).

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



Source: Eurostat.

– unemployment dropped to 3.6% in Q2, its lowest level in half a century, while activity and employment rates remained relatively high. The Fed estimates that positive labour market trends in the coming period will spill over onto the rest of the economy.

Measured by the personal consumption expenditure index, headline **inflation in the USA** also slowed down at the start of the year, to 1.4% y-o-y on average in Q1, driven mainly by the fall in energy prices, and remained there in Q2 as well. Excluding the prices of food and energy, inflation declined to 1.6% y-o-y in Q1, and then to 1.5% y-o-y on average in Q2, which is below the 2% target. Domestic inflationary pressures remained low, given that wages did not rise at a rate that could push inflation up, while global disinflationary pressures persisted.

The Central and Southeast European region recorded a positive growth rate since the start of the year, driven mainly by sound domestic demand and increased wages and employment. The biggest rise in economic activity was recorded by the leading economies in this region (Poland, Hungary, Romania), which relied on stable private consumption supported by the development of the domestic labour market, EU funds and favourable financial conditions. Hence the growth estimates for this region remain optimistic going forward.

Since the start of 2019, **inflation in Central and Southeast Europe** trended up on the back of the rising prices of food and energy, only to slow down in most countries in June, under the impact of falling global oil prices. The rise in wages and domestic demand continued to generate moderate inflationary pressures in these countries, while lower import inflation acted in the opposite direction. In Q1, having reached the highest level since early 2017 (5.2%), average y-o-y inflation in **Russia** declined to 5.0% in Q2 owing to the rouble's strengthening since the start of the year, as well as the dampened consumer demand. Inflation in **Turkey** continued to slow down in Q2, from 19.9% y-o-y in Q1 to 18.0% y-o-y on average in Q2, and in June it fell to the lowest level in 12 months (15.7% y-o-y) as a result of past monetary policy tightening and dampened demand, as well as the high base effect.

According to Rosstat's flash estimate, having recorded the highest growth in ten years – 2.3% in 2018, **the Russian economy** slowed down in Q1 2019 to 0.5% y-o-y under the impact of declining consumption and investment activity, VAT increase since the start of 2019 and past monetary policy tightening. Still, it has been assessed that these are temporary factors and that Russia's economic activity will rebound in Q2 on account of the implementation of national projects and public investment. In addition, Q1 saw the best financial result of the Russian economy in 12 years, accompanied by declining unemployment and rising wages.

In Q1, **China's GDP** rose 6.4% annualised owing to capital investment and increased activity in the services sector, which made up for the dampened industrial activity. Yet, the preliminary assessment indicated that growth would slow down to 6.2% annualised in Q2 under the impact of a weaker pace of global growth and the prolonged trade tensions with the USA. Therefore, the authorities will continue with tax cuts, infrastructure projects and improvements to the business environment, while banks will continue to support small and micro-enterprises.

Monetary policy

During H1, leading central banks took up a somewhat more cautious stance to monetary policy normalisation and announced new stimulus against the backdrop of low inflation and increased risks of an additional downturn in global growth. To ensure a sustainable convergence of inflation towards the target of below, but close to 2% in the medium term, the **ECB** changed its interest rate guidelines. Though it was initially expected that the rates would remain unchanged not only until the end of summer, but through 2019, in its press release after the June meeting, the ECB announced that the rates would remain at record-low levels at least through H1 2020. Also, the ECB will continue reinvesting the principal payments from maturing securities under the asset purchase programme (which was concluded in December) past the date when it starts raising its key interest rate, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation. Moreover, the ECB announced in March that as of September 2019 and until March 2021, it will implement a new series of quarterly targeted longer-term refinancing operations (TLTRO-III), each with a maturity of two years. The goal of these operations is to preserve favourable borrowing conditions and facilitate the transfer of the effects of monetary policy measures.

During H1, the **Fed** changed its communication with regard to future monetary policy, stressing that it will be patient and flexible in its monetary policy pursuit. Having raised its target range in December, the Fed kept it at 2.25–2.50% in H1; however, heightened uncertainty as to prospects of economic growth and low inflationary pressures led to a fall in expectations regarding the future movements in the federal funds rate, resulting in a turn in the Fed's communication. A more cautious monetary policy is also reflected in a more flexible approach to the unwinding of the Fed's balance sheet. In its regular semi-annual address to the US Congress, the Fed Chairman voiced his concern over trade tensions, the UK's EU exit, dampened growth in advanced economies and the spill-over effects on the US economy. He also stressed that, after inflation trended below the target during H1, there was a risk of it remaining low longer than previously expected.

The change in the character of leading central banks' monetary policies alleviated the pressure on **central banks in the region** towards monetary policy tightening.

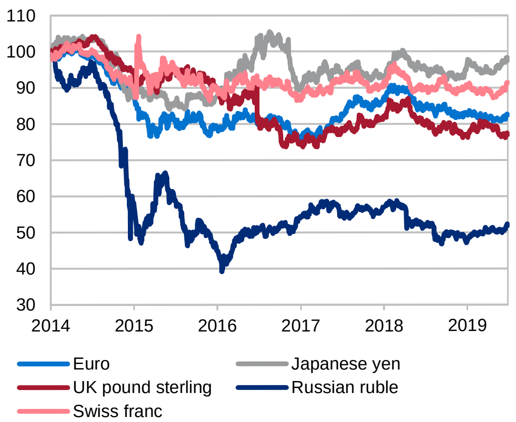
After raising its overnight deposit facility rate from -0.15% to -0.05% in March and keeping the key policy rate at 0.9%, the central bank of **Hungary** kept the rates on hold until end-H1. Though stepped-up demand at home and good labour market performance are pushing inflation up, subdued economic performance in the euro area is expected to have a restrictive effect on price growth. The central bank of **Romania** kept its key policy rate at 2.50% in H1, while the central bank of **Poland** maintained its key policy rate at 1.5%, where it has stood since March 2015. On the other hand, the **Czech** central bank raised its key policy rate by 25 bp to 2.00% in May, as anticipated by analysts. Though it kept its key policy rate unchanged in H1, amid the still high inflation, the central bank of **Turkey** temporarily suspended one-week repo operations at the rate of 24% on two occasions, thus turning banks towards costlier lending facilities at the rate of 25.5%. In late May it also raised the FX reserve requirement ratios by 200 bp. In June, for the first time since March 2018, the central bank of **Russia** trimmed its key policy rate – from 7.75% to 7.50%.

Financial and commodity markets

The upward trend of the value of shares, present since the start of the year, was disrupted in May due to new protectionist measures by leading world economies, which spurred concerns of market participants in terms of the outlook of global growth and inflation. Still, after the Fed gave clearer signals about the possibility of trimming the interest rate by year-end, global stock markets recovered in June, which was additionally supported by low yields on bonds as an alternative form of investment. During H1, the implicit measure of **financial market volatility** (VIX) dropped by 10.3 pp to 15.1%, while the volatility of emerging countries' currencies, measured by EM–VXY, declined by 1.5 pp to 8.2%.

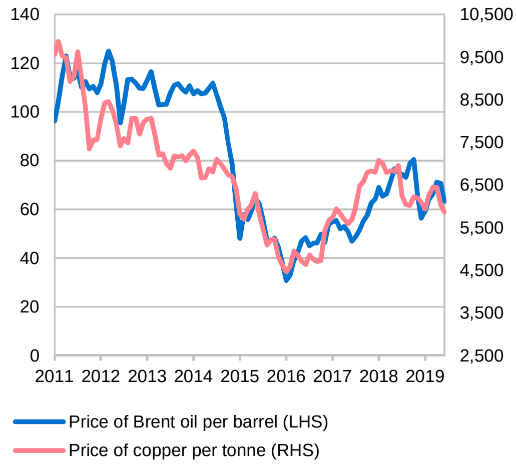
The exacerbated trade tensions between the USA and its main trade partners China and Mexico reflected on the **yields of ten-year US Treasuries**, which edged down 0.7 pp to 2.0% in H1, their lowest level since November 2016. As of end-May, the spread between the yields on ten-year and three-month US Treasuries has been in the

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



Source: IMF database.
* Growth indicates appreciation.

Chart III.1.4 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

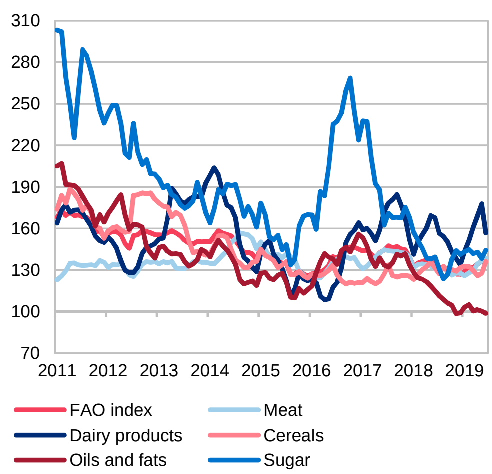
negative zone, thus sparking additional fears of recession. Yields on ten-year German government bonds, which are considered safe assets, entered the negative territory and reached their lowest level at end-June (-0.33%). Yields on the comparable French and Austrian bonds also entered the negative zone. Seeking to make profit, investors purchased bonds of peripheral countries in the euro area, which led to a decline in their yields in H1.

During Q1, **the euro** weakened **against the dollar** due to the relatively poorer prospects of growth in the euro area and increased investments in the dollar as a safe currency. However, the euro regained some of its value in Q2, following the Fed's June meeting which hinted at monetary policy accommodation. Thus, at end-H1, relative to end-2018, the euro was 0.6% weaker relative to the dollar. Having appreciated in Q1, the British pound dropped against the dollar in Q2 amid increased risk of a no-deal Brexit, hence its value remained negligibly changed at the level of H1 (a decline of 0.1%, end-of-period). The Japanese yen and the Swiss franc, both considered safe currencies, gained on the dollar by 2.9% and 0.6% respectively, as did the Russian rouble (by 10.2%).

At end-H1 **the global oil price** stood at USD 64.4 per barrel, up by 21.2% from end-2018. Though US production continued up, the rise in the oil price was significantly facilitated by other factors on the supply side – lower production by OPEC member countries, as well as the contracted production in Venezuela and Iran due to sanctions and the US decision to revoke sanction exemptions for countries that still buy Iranian oil. After reaching USD 74 per barrel in May, its highest level since October 2018, the price of oil fell by around 13% by end-June due to concerns over the global economic outlook amid tensions in international trade. In the second half of June, the price of oil resumed an upward trajectory, primarily owing to heightened geopolitical tensions between the USA and Iran which threaten to jeopardise major global oil supply chains. The oil price hike was backed by an agreement between the USA and China on resuming their talks, as well as the dollar's weakening in light of hints at the Fed's monetary policy easing.

Measured by the FAO index, **world food prices** were 7.1% higher at end-H1 than at end-2018. The price of dairy rose the most (17.2%), in anticipation of the

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



Source: FAO, UN.

seasonal decline in production. The price of meat followed suit, going up 8.4% mainly as a result of higher import demand in East Asia, aimed to offset the reduction in pork production at home, caused by an outbreak of African swine fever. The price of cereals went up 3.2%, driven by the rising prices of corn amid the anticipated lower export inventories of the USA, the world's major corn producer and exporter. Sugar prices also edged up (2.1%), mainly due to the decreased supply from Brazil and the EU. In contrast, the price of vegetable oil declined by 0.3%, driven by the lower prices of palm and soybean oil.

2 International transactions

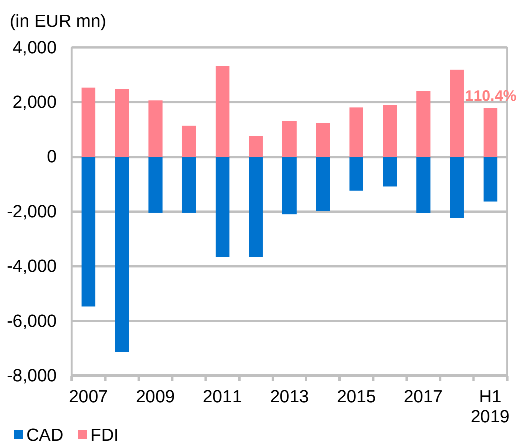
Balance of payments and FX reserves

According to preliminary data, the **current account deficit** in H1 2019 amounted to EUR 1.6 bn, up by EUR 548.0 mn from the same period a year before. This was mostly facilitated by the higher deficit on trade in goods, which went up despite an increase in foreign trade, given that import rose faster than export, supported by the ongoing investment cycle and the recovery in consumption, while the rise in export was partly limited by the lower external demand, as well as by one-off factors, such as the overhaul in the oil industry. At the same time, inflow to the financial account, mainly consisting of FDIs, was more than sufficient to cover the current account deficit, which added to appreciation pressures in H1. These movements resulted in a rise in FX reserves, thereby further increasing our economy's resilience to potential negative impacts from the international environment.

The export of goods increased by 8.5% relative to H1 2018, and the import rose slightly faster (10.2%), therefore the **deficit on trade in goods** widened by EUR 366.3 mn to EUR 2.7 bn. Driven by the manufacturing exports, the **export of goods** equalled EUR 8.1 bn in H1. Manufacturing exports increased 5.3% y-o-y – according to foreign trade data, the main contributors were the export of electric equipment (23.8% y-o-y), machines and equipment (22.6% y-o-y) and rubber and plastic products (11.6% y-o-y). A significant contribution also came from the export of agricultural products, which rose 33.3% y-o-y in H1. This was mainly facilitated by the increased export of cereals, which came at EUR 393.1 mn in H1, up by EUR 129.0 mn from H1 2018. At the same time, the **import of goods** rose to EUR 10.8 bn, owing to the industry's greater demand for equipment and intermediate goods, in order to meet the demands of the ongoing investment cycle, as well as to the higher import of consumer goods, which is indicative of a recovery in household consumption. According to SITC, the highest increase in imports relative to the same period last year was recorded for chemical products (12.6%), notably pharmaceuticals, followed by metal ores (70.7%), energy (9.6%), other transport equipment (147.3%), and iron and steel (21.7%).

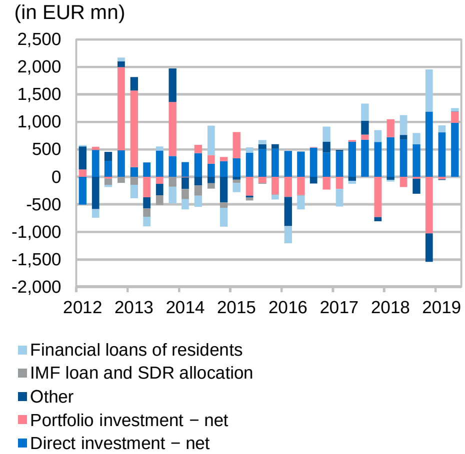
The surplus in the **trade in services** measured EUR 461.9 mn and was slightly lower (by 2.4%) than in H1 2018. The rise in export was mostly facilitated by information-communications and business services,

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



Sources: SORS and NBS.
* Preliminary data.

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



Source: NBS.
* Preliminary data.

while business and tourist services gave a contribution on the import side.

Table III.2.1 **Serbia's balance of payments**
(in EUR mn)

	H1 2018	H1 2019
I CURRENT ACCOUNT	-1,078.3	-1,626.3
1. Goods	-2,295.3	-2,661.6
1.1. Credit	7,502.5	8,137.7
1.2. Debit	-9,797.8	-10,799.3
2. Services	473.3	461.9
2.1. Credit	2,683.1	3,131.6
2.2. Debit	-2,209.8	-2,669.7
3.Goods and services	-1,822.1	-2,199.7
3.1. Credit	10,185.6	11,269.3
3.2. Debit	-12,007.7	-13,469.1
4. Primary income	-1,155.8	-1,184.8
5. Secondary income	1,899.6	1,758.2
II CAPITAL ACCOUNT	3.0	-41.4
III FINANCIAL ACCOUNT (excluding reserve assets)	1,908.6	2,132.9
1. Direct investment, net	1,405.6	1,795.6
2. Portfolio investment, net	147.1	152.4
3. Financial derivates, net	-6.5	14.8
4. Other investment, net	362.5	170.2
4.1. Trade credit and advances	-263.3	-328.0
4.2. Financial loans	329.1	193.2
4.3.Currency and deposits, net	296.0	305.2
4.4. Other, net	0.7	-0.1
IV Reserve assets	-1,072.6	-784.3
V NET ERRORS AND OMISSIONS	239.3	319.0
VI OVERALL BALANCE	1,072.6	784.3

Source: NBS.
Note: Preliminary data.
[1)] BPM6 methodology, except sign convention.

At the same time, the deficit on the **primary income account** increased slightly (by 2.5% y-o-y) and equalled EUR 1.2 bn in H1. This is primarily attributable to the higher expenditures on account of portfolio investments (by 10.7%) and other investment, i.e. interest (by 15.0%), mainly due to coupon payments for government securities issued during H1 2018, which were bought by non-residents, while FDI expenses were 1.8% lower.

The surplus on the **secondary income account** decreased by 7.4% to EUR 1.8 bn in H1. This is mainly due to the lower net inflow of other transfers (mostly as a consequence of the tarrifs on the goods delivered to Kosovo and Metohija). The net inflow of remittances equalled EUR 1.5 bn in H1 and was slightly lower than in the corresponding period last year.

In H1 2019, **inflow to the balance of payments financial account** (EUR 2.1 bn)[6] was 11.8% higher than in the same period in 2018. FDIs accounted for the bulk of the capital inflow from abroad and were more than sufficient to fully cover the current account deficit, as was the case in the past four years as well. Capital inflow was also achieved on account of portfolio investment, as well as the increased cross-border borrowing by the government and corporates.

Net **FDI** inflow came close to EUR 1.8 bn in H1 2019, up by 27.7% relative to H1 2018. The FDI in Serbia, which reached EUR 1.9 bn (around 9% of estimated GDP), remained diversified by project in H1 and were mostly channelled to tradable sectors, which will enable a further expansion in the export base going forward. The biggest amounts were invested in manufacturing (25%), construction (22%), financial activities (16%) and transport (9%). Almost three-quarters of the FDI inflow came from EU countries, while 9% of the inflow was investment from Asian countries.

Portfolio investments garnered a net inflow of EUR 152.4 mn, up by 3.6% from H1 2018. This inflow was mainly a result of increased foreign investors' interest in government long-term dinar securities in the Serbian market, in conditions of a favourable macroeconomic perspective for Serbia and the announcements of a slower monetary policy normalisation by leading central banks than previous expected. The growing confidence of foreign investors was confirmed in the international market in June, when, after a six-year break, the ten-year eurobond was issued under financial conditions that are more favourable to Serbia than ever before. All of the assets obtained through this issue (EUR 1.0 bn) were used for the replacement of the dollar debt issued at higher interest rates, i.e. for the early purchase of a portion of dollar bonds maturing in 2020 and 2021.[7]

The inflow from **other investments** in H1 equalled EUR 170.2 mn, down by EUR 192.3 mn from H1 2018. Of this, resident borrowing under **financial loans** increased by EUR 193.2 mn net in H1, facilitated by the rise in government borrowing (by EUR 257.9 mn) and corporate borrowing (by EUR 204.4 mn). On the other hand, banks repaid EUR 265.0 mn net, and the NBS trimmed its obligations by EUR 4.1 mn. In the same period, banks decreased their foreign deposits by EUR 183.2 mn, while non-residents increased their deposits with domestic banks by EUR 122.0 mn. Hence, the registered inflow from **cash and deposits** equalled EUR 305.2 mn net.

[6] Excluding a change in FX reserves.

[6] See Text box 1 in the *Inflation Report – August 2019*.

Exporters approved more trade loans than were used by our importers – as a result, a net outflow of EUR 328.0 mn was recorded for **trade loans**.

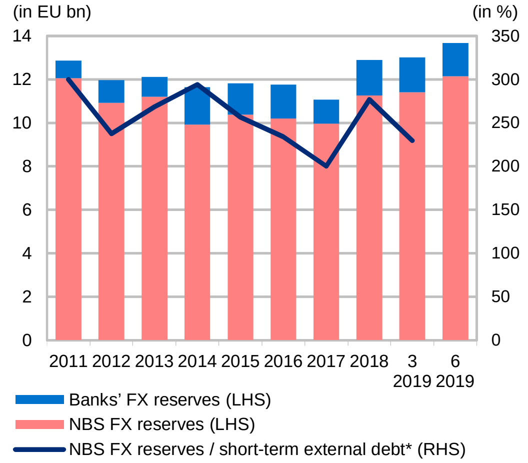
Owing to the above trends in the current and financial accounts, **Serbia's FX reserves** (according to the balance of payments methodology)[8] expanded by EUR 784.3 mn in H1.

At end-June 2019, gross and net FX reserves of the NBS were at their record-high since 2000, when the data were first tracked in this manner. Gross NBS FX reserves equalled EUR 12,146.0 mn on 30 June 2019 and were up by EUR 884.2 mn from end-2018. The net effect of FX transactions was positive (the FX inflow exceeded the FX outflow) at EUR 740.4 mn, as were net market effects (currency changes, changes in the price of gold and market value of securities) which amounted to EUR 143.8 mn. At end-June, FX reserves ensured the coverage of money supply M1 with 185% and more than five months' worth of the import of goods and services, which is almost twice higher than the standard on the adequate level of reserves. Net FX reserves rose EUR 1,288 mn from end-2018 to EUR 10,142 mn.

Consistent with the fundamental principles of security and liquidity, the funds were invested in highly liquid securities issued by the most advanced countries in the world and international financial institutions, as well as placed with prime institutions (central banks, international financial institutions and top tier foreign banks). In regard to this, as at 30 June 2019, foreign securities accounted for the bulk of FX reserves (54.3%), followed by FX balances in accounts abroad (26.0%), foreign cash (12.2%), gold (6.9%) and SDRs with the IMF (0.6%).

In H1, the NBS recorded an FX inflow of EUR 974.9 mn in respect of the issuance of long-term euro-denominated government securities in the amount of EUR 1.0 bn in the international financial market for the purpose of the early purchase of a portion of dollar eurobonds totalling USD 1.1 bn, which were issued in 2011 and 2013. In addition, the NBS recorded an FX inflow of EUR 560.3 mn in respect of the sale of euro-denominated government securities in the domestic financial market. The NBS recorded an FX inflow from IFEM[9] interventions in the amount of EUR 935.0 mn net: EUR 910.0 mn from interventions (bought EUR 1,040.0 mn from banks and sold EUR 130.0 mn to banks) and EUR 25.0 mn from additional two-week swap auctions. In addition, the NBS recorded an FX inflow of EUR 482.6 mn on account of the disbursement of loans for the Republic of Serbia, EUR 79.7 mn from donations and EUR 66.4 mn from temporary payment operations with Kosovo and Metohija.[10] In respect of investment in foreign securities and interest rates on FX funds, the NBS recorded an inflow of EUR 43.2 mn net.

Chart III.2.3 **FX reserves and coverage of short-term external debt**



Source: SORS.
* Short-term debt by remaining maturity.

An outflow of EUR 1,030.6 mn from the FX reserves was recorded in respect of the partial purchase of the government dollar eurobond. A total of EUR 748.3 mn was paid in respect of maturing euro-denominated government securities in the domestic financial market. Obligations to foreign creditors (principal and interest) were settled regularly, amounting to EUR 598.2 mn in H1, while EUR 2.9 mn was paid pursuant to the Law on the Settlement of the Public Debt of the Republic of Serbia Arising from Unpaid Foreign Exchange Savings of Citizens.

International investment position

At end-Q2 2019, Serbia's international investment position of a net debtor equalled EUR 38.6 bn, up by EUR 1.3 bn compared to end-2018. The increase is mostly due to the rise in the most desirable investment from abroad – **FDI, whose net stock at end-Q2 reached 86% of the**

[8] Excluding currency changes, a change in the market value of securities and the price of gold.

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

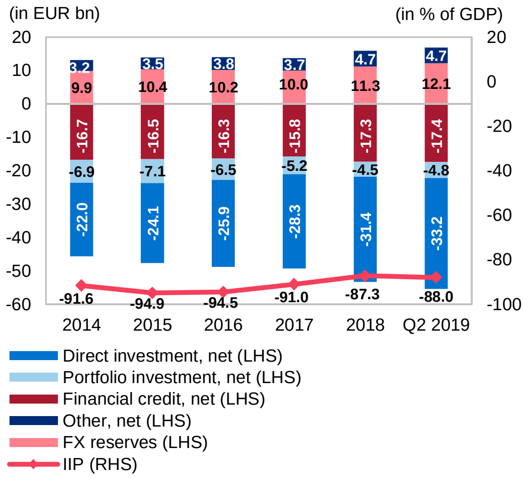
[10] Under the Law on Temporary Execution of Certain Payment Operations in the FRY (FRY Official Gazette, No 9/01).

net international investment position. Low inflation and the relative stability of the exchange rate were conducive to a more favourable investment climate and, consequently, a high inflow of FDI, which is significant in terms of the sustainability of Serbia's external position. **The high FDI inflow reflected on the increase in the share of Serbia's net international investment position in estimated GDP**[11] to 88.0% in Q2, up by 0.7 pp from end-2018.

Serbia's foreign financial assets went up EUR 1.8 bn in H1, to EUR 26.3 bn. The increase is driven by balance of payment transactions (EUR 1.6 mn) and currency and other changes (EUR 161.4 mn). As for the composition of financial assets, **other resident investment** abroad increased the most (EUR 703.6 mn), mainly owing to a rise in trade loans and advance payments to non-residents (EUR 826.4 mn), while resident cash and deposits abroad decreased (EUR 176.1 mn). The country's **FX reserves** still constituted the bulk of total assets (46.3%). Resident **FDI** abroad also went up in H1, by EUR 190.8 mn, hence claims on this account amounted to EUR 3.5 bn. As **portfolio investment** of residents abroad went up by EUR 18.7 mn, the stock of foreign securities owned by investors from Serbia equalled EUR 267.3 mn at end-Q2.

External financial liabilities of Serbia rose to EUR 64.9 bn in H1. The increase was largely a result of the executed

Chart III.2.4 **International investment position***



Source: NBS.
* Preliminary data.

transactions, worth EUR 3.0 bn, and to a lesser extent of currency and other changes – EUR 128.5 mn. In terms of the structure of financial liabilities, the positive trends from previous years continued – foreign liabilities of residents rose in H1 as well and were a result of the increase in **FDI**, which went up EUR 2.0 bn to EUR 36.7 bn. Owing to the continued rise in FDI, resident liabilities on this account still exceed one half of total foreign liabilities, accounting for 56.6% of total liabilities. Relative to end-2018, FDI growth mainly related to the increase in equity capital (EUR 1.1 bn), while foreign investments in debt instruments were lower (EUR 900.1 mn). The rise in total liabilities was also facilitated by the increase in **other investments**, by EUR 807.9 mn, therefore they equalled EUR 23.1 bn at end-Q2, or 35.6% of total liabilities. In the structure of other investments, as with assets, the largest increase was recorded with trade loans and advances. Resident liabilities arising from **portfolio investment** expanded on account of balance of payment transactions and currency and other changes in the international financial market – they rose EUR 288.0 mn and equalled EUR 5.1 bn or 7.8% of total liabilities at end-Q2.

3 Financial market trends

Interest rates

Although the NBS's key policy rate remained unchanged in H1, the average repo rate[12] declined on the back of excess dinar liquidity by 0.6 pp, coming almost to the level of the deposit facility rate at end-June (1.76%).

Responding to temporary contraction of excess liquidity early in the year, the NBS organised additional FX swap auctions as of January to ensure unhindered functioning of the interbank money market and maintain relative stability of short-term market interest rates. This helped supply the necessary dinar liquidity to banks and prevent concentration of excess liquidity in a smaller number of banks, as well as unjustifiable growth of interest rates in the money market.

In H1, BEONIA dropped by 0.6 pp to 1.85%, despite an almost 20% increase in the average daily turnover relative to H2 2018. BELIBOR rates of shorter maturities mirrored BEONIA movements, declining by around 0.3 pp. On the other hand, interest rates on three- and six-month maturities declined to a somewhat lesser degree

[11] Estimated GDP in the past four quarters.

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

(by 0.1 pp each), so BELIBOR rates ranged between 2.3% and 3.1% at end-June.

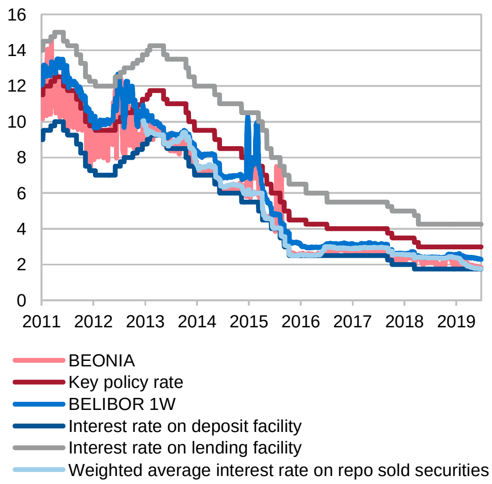
The primary market of dinar government securities saw the issuance of new benchmark dinar bonds since the start of the year, with the maturities of three and seven years. Higher demand, particularly non-resident, was registered since May, pushing down the rates on these government securities to 3.4% and 4.4%, respectively in June. Compared to the first auctions of these securities held in January, June interest rates decreased by 0.3 pp for the three-year maturity and by 0.2 pp for the seven-year maturity. In addition, one auction of a five-year dinar bond was held in February, at the interest rate of 4.0%.

H1 saw the sale of dinar securities in nominal amount of RSD 199.7 bn, with the stock of sold dinar securities rising by RSD 20.6 bn, to RSD 741.9 bn. Non-residents increased investment in dinar securities by RSD 27.9 bn, to RSD 234.2 bn at end-June, or 31.6% of the entire stock of sold dinar securities.

Since the beginning of the year, the NBS also organised **auctions of euro-denominated securities** with maturities of two, three, five, ten and fifteen years. Interest rates at auctions of up to five-year maturities declined relative to the start of the year (from 0.1 pp to 0.3 pp) ranging between 0.8% for the two-year maturity to 1.5% for the five-year maturity at end-June. The achieved yield rates at auctions of ten- and fifteen-year maturities in January and February were 3.25% and 3.6%, respectively.

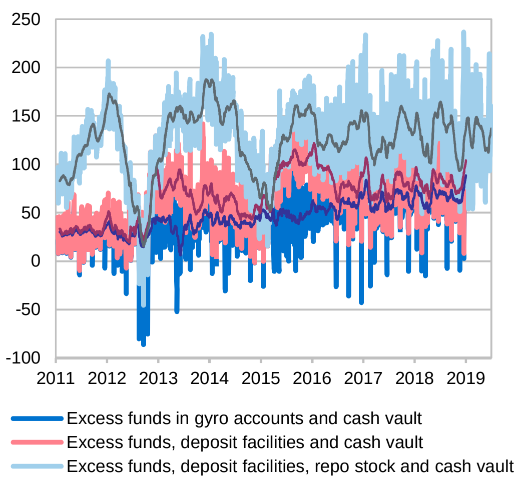
The nominal amount of euro securities sold in H1 was EUR 575.8 mn, which did not suffice to cover the maturing amounts, so the stock of euro securities sold dropped by EUR 84.4 mn, to EUR 2,784.6 mn at end-June.

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



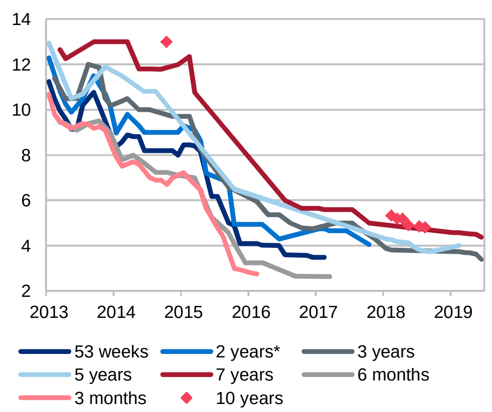
Sources: Thomson Reuters and NBS.

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



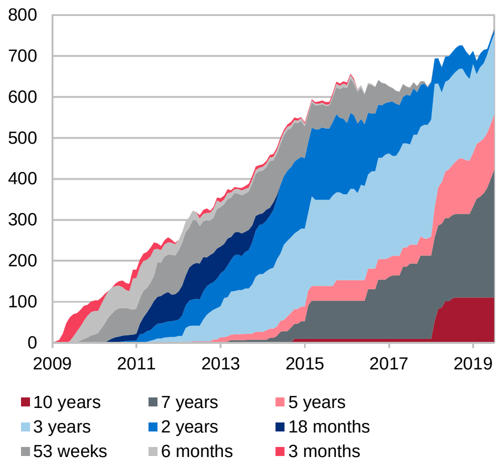
Source: NBS.

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



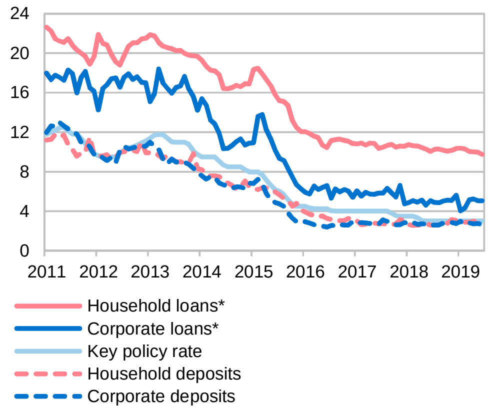
Source: Ministry of Finance.
* Excluding coupon securities with the rate linked to the NBS key policy rate.

Chart III.3.4 **Stock of sold dinar government securities**
(in RSD bn)



Source: Ministry of Finance.

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



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

Yield rates on dinar securities in the **secondary market**, similarly to the rates achieved at the primary market, decreased up to 0.4 pp, depending on maturity. During June, yield rates ranged from 2.6% for the remaining three-month maturity to 4.35% for the remaining nine-year maturity (104 months). Total trading in dinar securities in the secondary market in H1 amounted to RSD 192.8 bn, down by 25% compared to the same period last year.

The weighted average interest rates **on new dinar corporate and household loans** dropped by around 0.6 pp each since end-2018, measuring 5.1% for the corporate and 9.75% for the household sector in June.

In June, interest rates on new dinar household loans touched their new lows in the inflation targeting regime, dragged down mainly by interest rates on new cash loans which slid 0.7 pp since December, dropping to 10.05% in June.

A decline in interest rates on new dinar corporate loans in H1 was spurred by the fall in rates on current assets loans (1.0 pp), which were approved at 4.9% in June, and to a somewhat lesser extent also by the fall in rates on investment loans (by 0.5 pp) to 4.9%.

The weighted average interest rate on **new euro-indexed loans** to corporates stood at 2.8% in June, almost the same as in December 2018, while the rates on new investment loans also minimally oscillated in H1, around 3% where they stood in June.

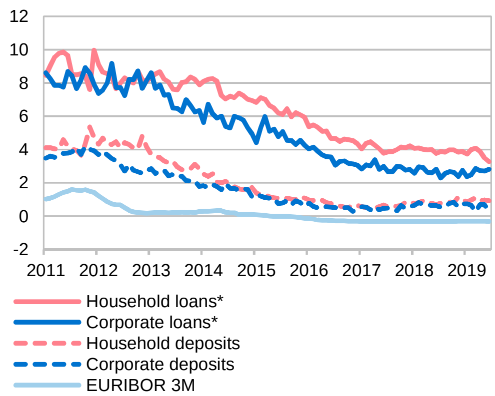
The price of euro-indexed household loans averaged 3.3% in June, or 0.6 pp less than in December 2018. Still, the decline in rates can be attributed primarily to the implementation of the Law on the Conversion of Housing Loans Indexed to Swiss Francs, which significantly boosted the share of housing loans in total newly approved euro-indexed household loans. Although the interest rate on new housing loans edged up by 0.2 pp from December to 3% in June, it still remained lower than the interest rate on loans intended for other purposes, so the higher share of housing loans in newly approved euro-indexed loans reduced the weighted average rate on new euro-indexed household loans.

H1 also saw a 0.1 pp decline in interest rates on household savings, to 3.0% on dinar savings and 0.9% on euro savings in June. Interest rates on dinar term deposits of corporates also edged down in H1, by 0.1 pp to 2.7%, while the rates on euro term deposits experienced a somewhat sharper fall (0.45 pp), averaging around 0.3% in June.

Country risk premium

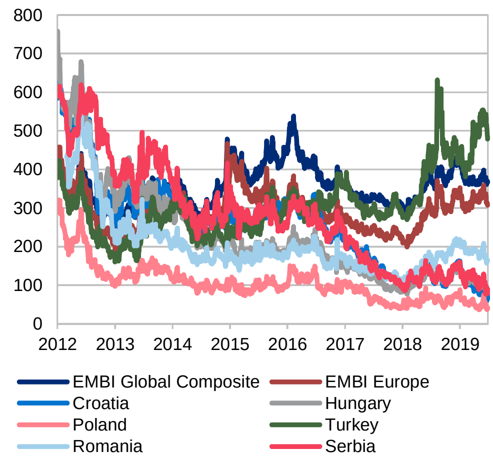
Early 2019 saw a decline in emerging markets' risk premia, driven mostly by the changed expectations as to the pace of normalisation of Fed's monetary policy which boosted investor readiness to put money into emerging markets. However, the tightening of global trade tensions and new protectionist measures by major world economies, as well as the deterioration of the global

Chart III.3.6 **Interest rates on new euro and euro-indexed loans and deposits**
(weighted average values, p.a., in %)



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

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



Source: JP Morgan.

growth outlook on that account, triggered a rise emerging markets' risk premium in May. This rise, however, turned out to be temporary in nature, mainly owing to announcements of leading central banks that they would slow down the process of normalisation of their monetary policies and the rising expectations that they would embark on a new cycle of monetary easing, which sparked investors' risk appetite. After June, emerging markets' risk premia turned downward on the end-June announcements of the US and China reaching an agreement on restraining from further protectionist measures for the time being. The composite measure EMBI Global Composite equalled 366 bp at end-H1, down by 69 bp relative to end-2018, despite the rise in the Venezuela's risk premium (by 2,022 bp) after the imposition of the US sanctions. The risk premium of European emerging markets, EMBI Europe, dropped by 32 bp to 307 bp at end-June, even though Turkey's risk premium went up by 49 bp.

Risk premia of the majority of countries in the region are much lower than EMBI Global Composite and EMBI Europe. Serbia's risk premium fell by 70 bp to 89 bp in H1, remaining among the lowest in the region, which proves that apart from global factors, domestic factors also contributed to the fall, primarily significant narrowing in internal and external imbalances, which reduced the need for external borrowing. Serbia experienced a decline in the EMBI risk premium despite the dropout from the calculation (end-January) of the eurobond maturing in 2020 whose yield was lower than the yield on eurobond maturing in 2021. In July, Serbia's risk premium dropped further, touching the new low of 59 bp and testifying to investors' confidence in favourable macroeconomic prospects of the domestic economy and their greater readiness to invest in Serbia.

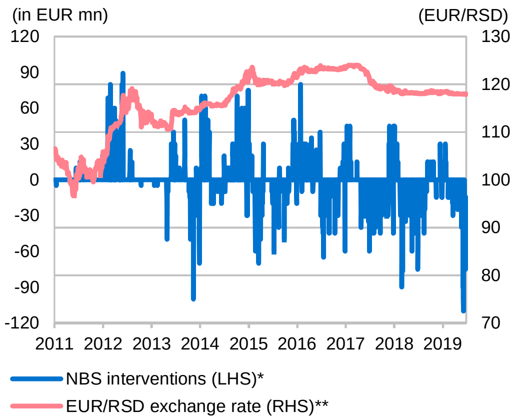
In May, Fitch affirmed Serbia's credit rating at BB, with a stable outlook. Speaking of factors that may lead to a rating upgrade, Fitch stressed further acceleration of economic growth and its medium-term sustainability, preservation of macroeconomic stability, stepping up structural reforms and further reduction in public debt.

Standard & Poor's kept Serbia's BB rating and affirmed a positive outlook in June, which was another positive signal to investors. The agency stated that the positive outlook reflected the expectation of economic growth remaining strong going forward, responsible fiscal policy and the government's commitment to continuing reforms, supported by the IMF arrangement. The agency particularly underlined the increased credibility of the NBS's monetary policy and the preserved price and financial stability as the factors underlying the positive outlook.

Trends in the FX market and exchange rate

After moderate depreciation pressures in January, spurred mainly by the seasonal hike in FX demand of energy importers, the appreciation pressures, which prevailed in the past two and a half years, set in again in February. The underlying drivers were mainly growth in exports and

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

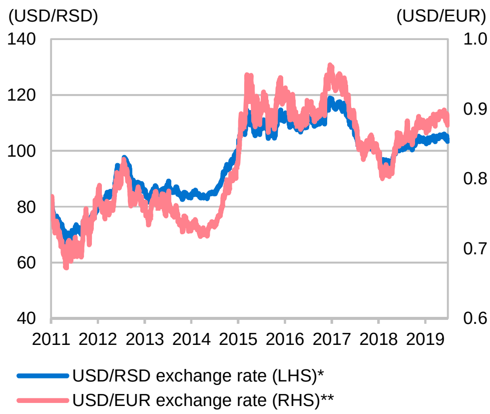


Source: NBS.

* + sale; - purchase.

** 1 EUR in RSD.

Chart III.3.9 **Movements in RSD/USD and EUR/USD exchange rates**



Source: NBS.

* 1 USD in RSD.

** 1 USD in EUR.

FDI which resulted in a significant contraction of net FX sales to enterprises from February onwards. The rise in FX-indexed corporate lending, i.e. increase in FX-indexed bank assets[13], also fuelled appreciation pressures since March. Higher purchases of foreign cash and non-resident card payments in Serbia, posting a seasonal hike in Q2, worked in the same direction. Appreciation pressures stepped up since June, mainly owing to great investor interest and growth in non-resident investment in long-term dinar government securities.

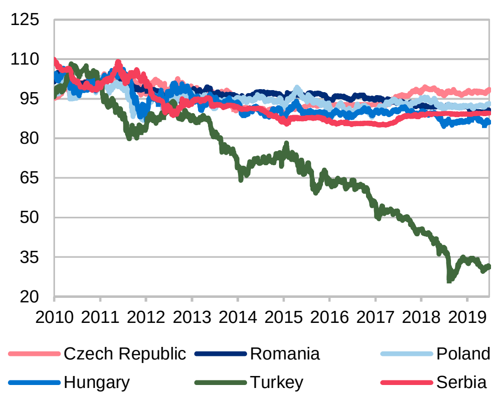
To ease excessive short-term volatility of the dinar against the euro, in H1 the NBS intervened in the IFEM purchasing EUR 955.0 mn net. The NBS intervened on the sale side only in January, with EUR 130.0 mn, whilst buying foreign currency in all other months (the monthly peak of EUR 735.0 mn was recorded in June).

In such conditions, the dinar's value against the euro at end-June increased by 0.2% relative to end-2018. At the same time, as the euro weakened against the US currency end-of-period, the dinar lost 0.4% relative to the dollar in H1.

The average daily trading volumes in the IFEM in H1[14] equalled EUR 23.0 mn, up by EUR 7.4 mn from the same period last year. The highest turnover was recorded in June (daily average of EUR 24.8 mn).

Other currencies of regional peers running similar exchange rate regimes displayed divergent movements in

Chart III.3.10 **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.

H1. The currencies which gained ground end-of-period were the Czech koruna and Polish zloty (1.1% each), while the Hungarian forint weakened by 0.6%, Romanian leu by 1.5% and Turkish lira by 8.1%.

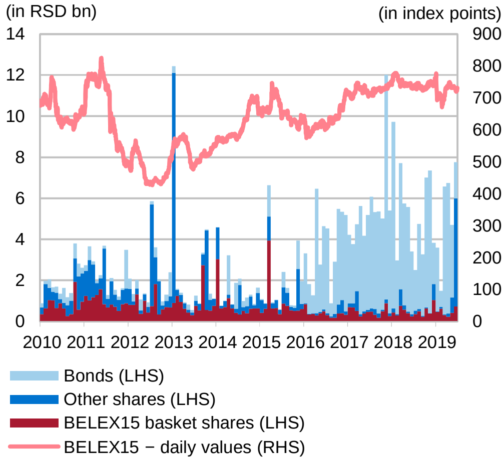
Stock exchange trends

In H1 2019, BELEX15 and BELEXline oscillated in both directions. After a decline early in the year, share prices gained ground by the end of June. At end-June BELEX15 reached 731.6 index points, down by 3.9% from end-

[13] Aiming to balance their open long FX position and thus reduce the exposure to FX risk, banks sell foreign currency, which leads to strengthening of the dinar.

[14] Excluding the NBS.

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



Source: Belgrade Stock Exchange.

2018, while the general index BELEXline lost 3.4%, measuring 1,535.3 index points in June. Belex indices bucked the trend of the majority of regional peers, which were at higher levels in June than at end-2018. Indices at Montenegrin and Romanian stock exchanges posted the highest growth (19.7% and 19.4%, respectively), while the Macedonian peer recorded a slight decline (1.1%).

Total share trading of RSD 9.1 bn almost tripled from H2 2018. However, two block transactions of one issuer in June accounted for almost 58% of the total share trading. In H1, foreign investors' participation in total trading was 46.5%, and they net sold RSD 5.3 bn worth of shares. BELEX15 shares accounted for 30.5% of the trading.

Relative to H2 2018, total trading in bonds contracted by RSD 2.7 bn, coming at RSD 21.8 bn. The entire turnover related to trading in long-term RS bonds.

In H1, BSE market capitalisation contracted by RSD 3.7 bn, measuring RSD 519.0 bn, or 10.0% of estimated GDP. Market capitalisation contracted mainly in the regulated market segment, whose market value dropped by RSD 18.6 bn, to RSD 280.8 bn in H1 (shares listed in the prime and standard segments accounted for the decrease of RSD 22.2 bn). Capitalisation of the MTP[15] segment increased by RSD 14.9 bn, reaching RSD 238.2 bn.

[15] MTP is a multilateral trading platform. It is set up by the Belgrade Stock Exchange and incorporates shares of companies that are currently not eligible for regulated market listing.

4 Money and loans

Monetary aggregates M1, M2 and M3

Credit and economic activity continued to provide a positive contribution to growth in monetary aggregates in H1. However, as the **favourable fiscal performance** extended into H1 of the current year, the rising government deposits in the banking system worked in the opposite direction.

In H1, monetary aggregate M1 shrank by 2.4%, while M2 expanded by 1.3% and M3 by 0.1%, due to the seasonal contraction in more liquid components and accelerated rise in dinar time deposits.

In terms of the dinar component of money supply, cash in circulation expanded by RSD 3.5 bn since the start of the year, while **demand deposits** contracted by RSD 22.3

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

	Dec. 2018	June 2019	Changes in 2019
Net foreign assets	**1,115,637**	**1,216,935**	**101,299**
Bank net foreign assets	-223,347	-224,151	-804
Net domestic assets of the banking sector	**1,490,216**	**1,392,174**	**-98,042**
Net domestic loans	2,607,225	2,509,996	-97,229
Net claims on government	345,646	184,466	-161,180
Government loans	646,691	637,370	-9,320
Government deposits	-301,045	-452,904	-151,860
Loans to other resident sectors	2,261,579	2,325,531	63,951
Loans to households	1,017,998	1,052,007	34,010
Loans to the corporate sector	1,188,180	1,208,481	20,301
Loans to other financial corporations	27,068	32,595	5,527
Loans to local authorities	26,730	30,396	3,666
Loans to non-profit and other organisations	1,603	2,052	449
Other net assets	-1,117,009	-1,117,822	-813
Money supply M3	**2,605,853**	**2,609,109**	**3,256**
Money supply M2	1,017,826	1,031,002	13,176
Money supply M1	792,332	773,513	-18,820
Currency in circulation	182,615	186,143	3,529
Sight deposits	609,717	587,369	-22,348
Dinar savings and term deposits	225,494	257,490	31,996
FX deposits	1,588,027	1,578,107	-9,920

Source: NBS.

bn amid a seasonal decrease in corporate account balances early in the year.[16] At the same time, households increased transaction deposits by RSD 14.6 bn, while account balances of other sectors remained close to end-2018 levels. In H1, **dinar time deposits** gained RSD 32.0 bn, with growth recorded across almost all sectors, testifying to the rising confidence in the domestic currency. The dynamic growth of dinar household savings recorded in 2018 (22.2%) extended into 2019. In H1 household savings deposits rose by RSD 8.2 bn, to RSD 68.6 bn in June.[17] The Analysis of profitability of dinar and foreign currency savings, regularly published by the NBS (the latest one covering the period from June 2013 until June 2019), also speaks in favour of greater profitability of saving in domestic currency, both in the long- and short-term. The attractiveness of dinar savings is also boosted by higher interest rates on dinar than on FX savings, more favourable tax treatment and the preserved price stability and relative stability of the exchange rate.

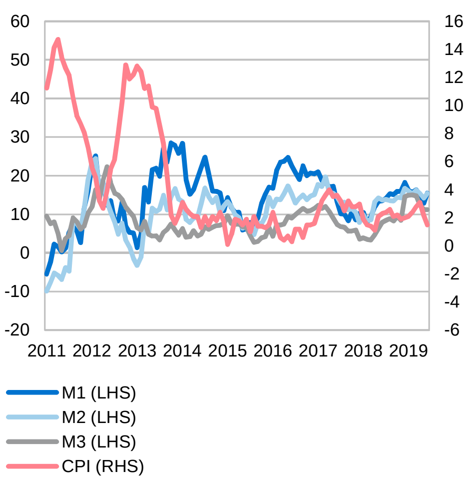
In H1, **FX deposits** declined by EUR 53.1 mn, due to the transfer to the government and payout of dividends under the concession of Nikola Tesla Airport (FX deposits of public enterprises went down by EUR 555.7 mn). On the other hand, thanks to good export results, FDI inflow and external borrowing, FX deposits of corporates went up by EUR 117.1 mn. Household FX savings also increased, by EUR 418.0 mn in H1 to EUR 10.1 bn at end-June (i.e. EUR 10.4 bn with non-resident funds included).

Bank loans

Excluding the exchange rate effect, total domestic loans[18] increased by 3.2% in H1, driven both by corporate (2.3%) and household lending growth (3.8%). The share of domestic loans in estimated GDP edged up by 0.2 pp from end-2018 to 43.6% at end-H1. **In y-o-y terms**, excluding the exchange rate effect, domestic loans grew by 9.4% in June (9.9% December 2018) – with corporate loans accelerating to 8.9% (from 8.1% at end-2018) and household loans slowing down to 9.7% (from 12.5% at end-2018).

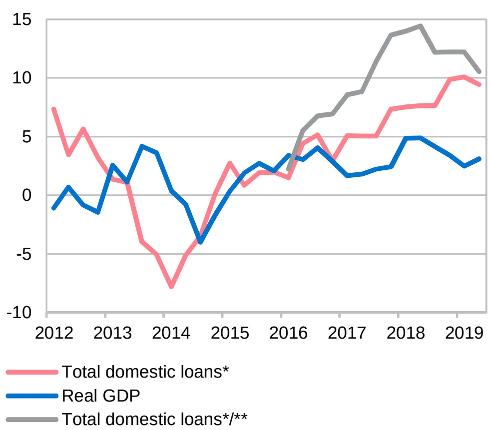
Banks' NPL resolution activities continued in 2019 with the write-off of RSD 7.0 bn worth of NPLs and the sale of another RSD 3.1 bn to non-banking entities, directly from the balance sheet in H1. **Excluding the effect of NPL write-off and sale,[19] y-o-y growth of domestic loans reached 10.5% in June 2019, with household loans rising by 10.2% and corporate loans by 10.6%, y-o-y.**

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



Sources: SORS and NBS.

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



Sources: NBS and SORS.
* Excluding the exchange rate effect.
** Excluding the effect of NPL write-off and sale since early 2016.

[16] They declined by RSD 47.8 bn in Q1 and rose by RSD 16.5 bn in Q2.

[17] With non-resident funds included, dinar savings equalled RSD 69.3 bn at end-June.

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

[19] Excluding the NPL write-off and sale effect since the beginning of 2016. Concluding with June 2019, banks wrote off RSD 189.3 bn worth of NPLs (of which RSD 140.4 bn of corporate loans and RSD 44.0 bn of household loans), and sold RSD 91.9 bn worth of NPLs, which were on their balance sheets at the time.

In financing credit activity in 2019, banks continued to rely more on domestic sources of funding, primarily on corporate and household deposits, and to a lesser extent on foreign loans.[20]

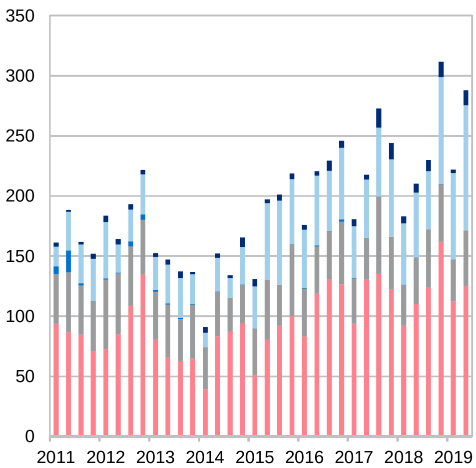
After a seasonal contraction early in the year, excluding the exchange rate effect, **corporate loans** gained RSD 26.3 bn in H1 2019, driven by the growth of company loans. **Sector-wise**, companies in construction, real estate, transport and trade recorded the strongest lending growth. **In terms of purpose**, investment loans took the lead in the segment of corporate loans since May, reaching 41.9% at end-H1. Current assets loans accounted for 41.2% of total corporate loans in June, while non-categorised loans made up 11.3%.

The volume of new corporate loans in H1 (RSD 509.8 bn) rose by 29.7% from the same period last year, or by 20.2% excluding the loans refinanced with the same bank. Enterprises continued to mainly seek current assets loans (RSD 237.7 bn) which made up 46.6% of total new corporate loans in H1, and were mainly channelled (almost 70%) to the SME segment of the market. The amount of new investment loans approved in H1 (RSD 176.0 bn) increased by 67.3% y-o-y, or by 62.5% excluding the loans refinanced with the same bank – which signals the continuation of positive trends in company investment. Their share in total new corporate loans was on the rise, reaching 34.5% in H1, while non-categorised loans accounted for 15.9% of the approved loans.

The results of the NBS's Bank Lending Survey[21] indicate that corporate credit standards remained almost unchanged in the past four quarters. In banks' view, competition in the banking sector continued to work toward standard easing in H1; corporate credit conditions were relaxed as regards collateral requirements and longer maximum maturity, with mild upward adjustment of interest margins on FX-indexed loans. Banks reported that the main drivers of corporate credit demand were SMEs, followed by large enterprises, while farmers also gave a significant contribution in Q2. Capital investment and current assets financing were identified as the dominant factors driving corporate loan demand.

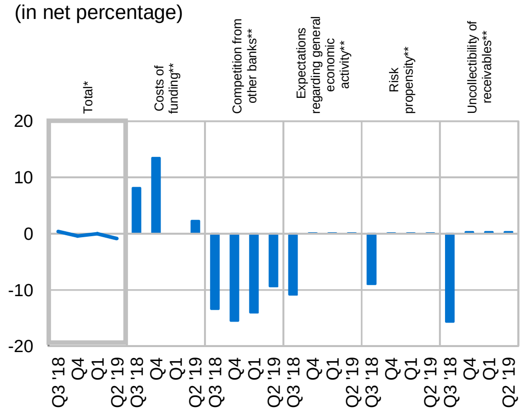
Excluding the exchange rate effect, **household loans** increased by RSD 38.6 bn in H1. They were driven by the expansion of cash and housing loans which remained the two dominant categories in June, accounting for

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



Source: NBS.

Chart III.4.4 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to enterprises**
(in net percentage)



Source: NBS.

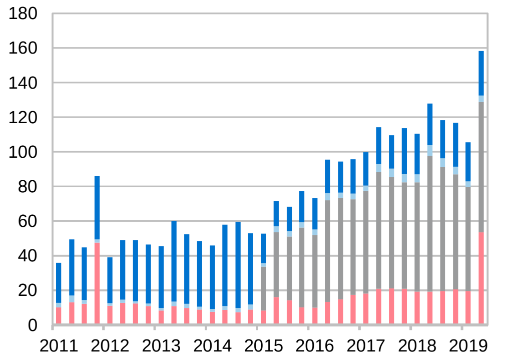
* Positive values indicate tightening and negative easing of credit standards relative to the previous quarter.

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

[20] In H1 2019, loan-to-deposit (LTD) ratio edged up by 2.5 pp to 94.9%.

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

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

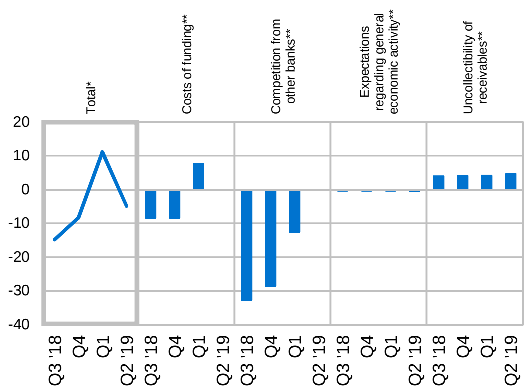


Source: NBS.

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

41.8% and 36.5% respectively of all bank household receivables. In H1 cash loans increased by RSD 28.4 bn, or RSD 4.2 bn less than in the same period last year, which confirms that the NBS's measures aimed at curbing non-purpose lending to households at unreasonably long maturities adopted in December 2018 are yielding results. At the same time, housing loans went up by RSD 1.0 bn, on the back of the real estate market recovery, favourable labour market trends and lower lending interest rates, while conversion of Swiss franc into euro loans worked in the opposite direction, given that under the Law on the Conversion of Housing Loans Indexed to Swiss Francs, 38% of the value of converted loans is written off at conversion.

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



Source: NBS.

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

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

The volume of new household loans in H1 amounted to RSD 263.9 bn, up by 10.7% from the same period last year or by 1.7% excluding the loans refinanced with the same bank. Cash loans were the dominant category, accounting for 51.3% of total new household loans in H1. However, the amount of new cash loans in H1 2019 dropped by 4.5% relative to H1 2018 – which suggests that the NBS's measures from December 2018 slightly moderated the growth in cash loans. The volume of new housing loans (RSD 73.0 bn) almost doubled y-o-y, or rose by 20.2% excluding the loans refinanced with the same bank. Higher amount of new housing loans partly stemmed from the recovery of housing lending and real estate market, but in greater part reflected the conversion of Swiss franc- to euro-indexed loans.

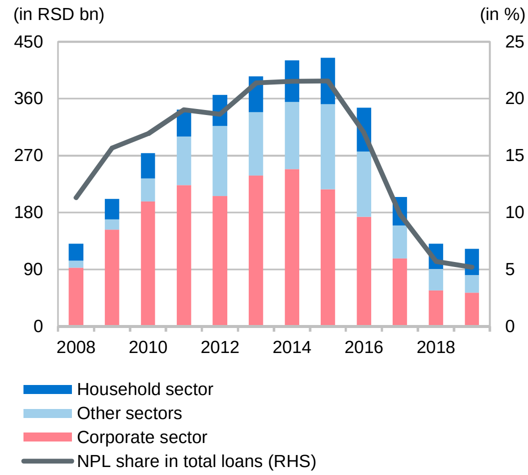
The results of the NBS's Bank Lending Survey show that household credit standards, after the tightening in Q1 which led to the shortening of maximum loan maturity, mildly relaxed in Q2. Price conditions were more favourable both for dinar and FX loans and collateral requirements were reduced. In banks' view, household loan demand increased, particularly in Q2, and the key underlying factors were the refinancing needs and real estate purchases.

Excellent results of the NPL Resolution Strategy, along with the economic and credit growth, brought the **level of NPLs** down by over 71% and their share in total loans by 17.2 pp in less than four years since the Strategy adoption. In H1, NPL share in total loans dropped by 0.5 pp to the new low of 5.2% in June, with the corporate NPL ratio decreasing by 0.4 pp to 4.6%,[22] and household NPL ratio staying at 4.4%[23]. NPL coverage remained high – allowances for impairment of total loans measured 79.5% of NPLs in June, while allowances for impairment

[22] Includes companies and public enterprises. Looking only at companies, the share of NPLs in total loans came at 4.7% in June, down by 0.5 pp from December 2018.

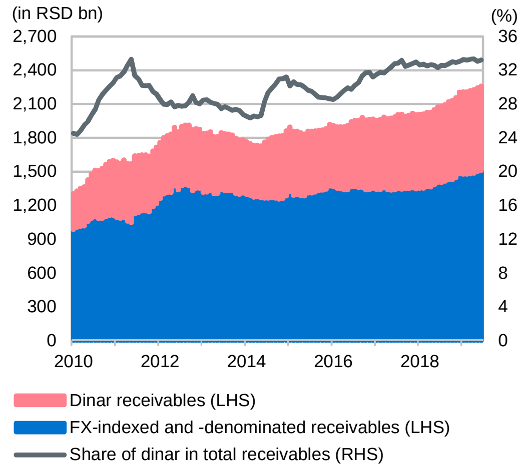
[23] If entrepreneurs and private households are included the share is also at the same level where it stood at the end of the last year – 4.4%.

Chart III.4.7 **NPL share in total loans, gross principle**



Source: NBS.

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



Source: NBS.

of NPLs stood at 60.8% of NPLs. Also, after the introduction of Basel III standards[24], the capital adequacy ratio rose further, to 23.2% at end-H1, indicating the high capitalisation of the domestic banking sector.

5 Dinarisation

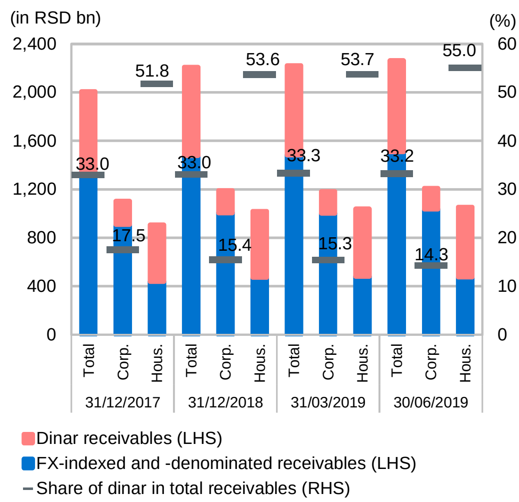
In H1, the NBS continued to implement activities aimed at bolstering the use of the dinar in Serbia's financial system.

Monetary policy measures implemented by the NBS helped preserve price stability, relative stability of the exchange rate and stability of the financial system, this being the key precondition for building up confidence in the dinar.

The reserve requirement policy was used to further encourage banks to rely more on dinar sources of funding. Namely, the required reserve ratios on dinar sources of funding are still significantly lower than those on FX sources, and the NBS remunerates only required reserves allocated in dinars, and not in foreign currency.

The NBS continued to work on the development of basic FX hedging instruments. In H1 2019, regular two-week and three-month FX swap auctions were organised, encouraging interbank swap trading and the development of instruments for liquidity management and hedging against FX risk.

Chart III.5.2 **Receivables by sector**

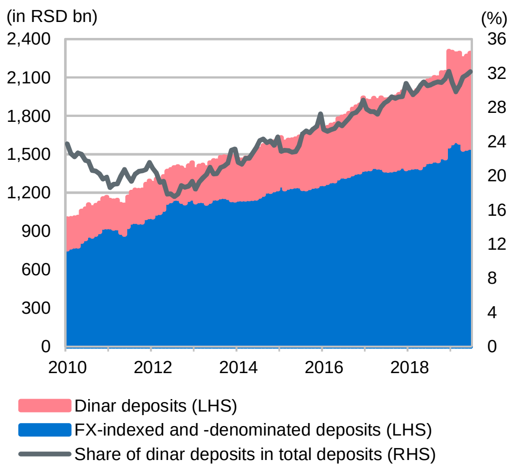


Source: NBS.

The degree of dinarisation, **measured as the share of dinar receivables in total corporate and household receivables**, increased by 0.2 pp in H1, measuring 33.2% at end-June. The said increase in dinarisation in 2019 is

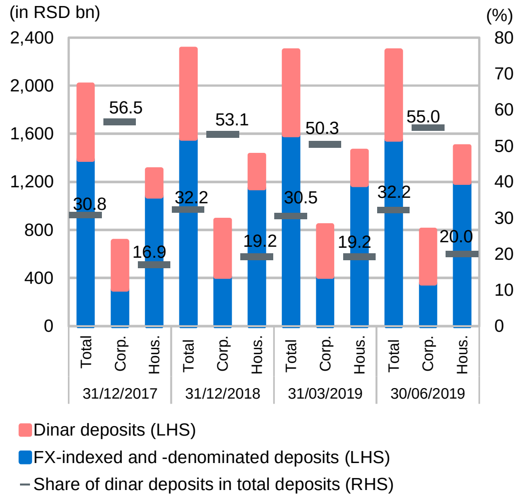
[24] The regulatory Basel III framework is applied as of 30 June 2017.

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



Source: NBS.

Chart III.5.4 **Deposits by sector**



Source: NBS.

attributable to household loans, which are typically approved in dinars. FX and FX-indexed loans to households increased negligibly in this period, reflecting the implementation of the Law on the Conversion of Housing Loans Indexed to Swiss Francs, pursuant to which banks wrote off a part of FX-indexed housing loans. These movements were conducive to a rise in the dinarisation of household receivables from 53.6% at end-2018 to 55.0% at end-June, this being the highest level of the indicator since its monitoring began in June 2008.

The degree of dinarisation of corporate receivables continued to decline in the same period. This indicator measured 14.3% at end-June, down by 1.1 pp from end-2018. Lower dinarisation of corporate receivables reflected the rise in FX-indexed and FX loans, as well as the drop in dinar loans. As for the composition of corporate loans, investment loans stepped up the most as they are a significant source of financing investment in equipment within the current investment cycle. Also, the fall in the dinarisation of corporate receivables remains aided by banks' NPL resolution efforts involving write-off and sale of a part of those receivables to non-banking sector entities, given that the bulk of them are in dinars.

Regarding the degree of dinarisation of deposits, **the share of dinar deposits in total corporate and household deposits with banks**, remained at 32.2% in June, its highest level on record, which is unchanged relative to end-2018.

Sector-wise, even though the share of dinar deposits in total household deposits is still relatively low (20.0% at end-June), this is the highest level since June 2008, more precisely since this indicator is monitored. From the beginning of 2019, this indicator increased (by 0.8 pp), owing to the rise in dinar transaction deposits of households, as well as to continued dynamic growth in dinar savings. The degree of dinarisation of corporate deposits went up in H1 (by 1.9 pp) to 55.0%, as a result of a significant decrease in FX deposits compared to those in dinars.

6 Real estate market

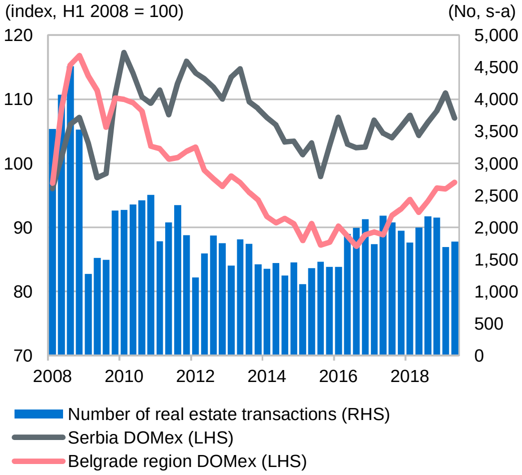
As suggested by supply and demand indicators, the real estate market saw further recovery in H1.

According to the data of the National Mortgage Insurance Corporation, the average price of real estate in Serbia, as measured by DOMex,[25] rose by 1.6% in H1 2019 relative to H2 2018, and by 2.9% y-o-y. Real estate prices exceeded their pre-crisis levels, ending H1 2019 10.8% higher relative to H1 2008.

According to the Republic Geodetic Authority, the average price of flats in Belgrade in Q1 2019 rose by 8.7% relative to 2018. The increased price of flats was partly prompted by the amendments to the Building Legalisation Law, which came into effect in November

[25] The DOMex is published by the National Mortgage Insurance Corporation and relates only to real estate purchased by insured loans.

Chart III.6.1 **DOMex and number of real estate transactions**



Source: National Mortgage Insurance Corporation.

2018 and envisage a ban on trade in real estate properties in the process of legalisation, until the final decision is made.

The recovery of the real estate market was also indicated by the number of flats completed in 2018, which rose by 28% relative to 2017, and amounts to 18,051, which is the highest number of completed flats in the last seven years (close to the pre-crisis figure – 19,815 in 2008).

Relative to H2 2018, the number of construction permits issued in H1 2019 increased by 7.6% s-a (in residential construction by 30.8% s-a), and by 4.0% y-o-y (in residential construction by 11.6%).

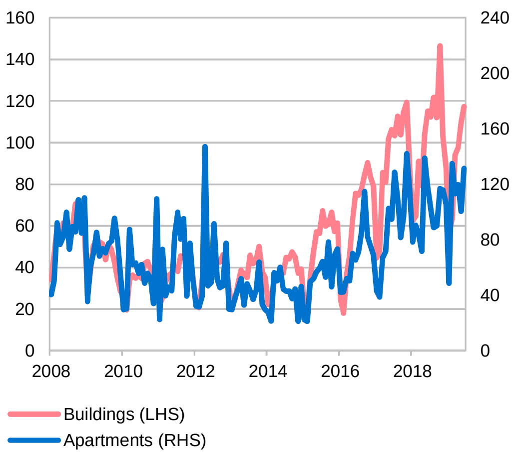
Higher disbursement of housing loans was also conducive to the recovery of the real estate market. According to the NBS Bank Lending Survey, banks expect that household demand for housing loans will continue to grow in the forthcoming period, which should continue to have a positive effect on real estate trade.

7 Inflation expectations

The financial and corporate sectors expect that over the next twelve months, and also over the medium run, inflation will remain low and stable within the NBS target tolerance band (3±1.5%). **In addition to confirming the credibility of the NBS, anchored inflation expectations enhance the efficiency of monetary policy and help to increase resilience of the domestic economy to shocks from the international environment**.

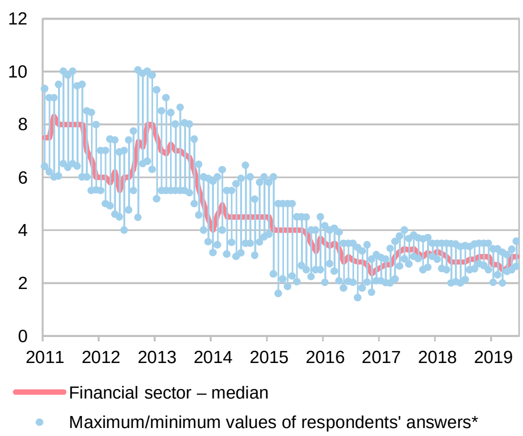
At H1 level, **short-term inflation expectations of the financial sector** moved around the target midpoint of 3.0%. According to the Ipsos survey, one-year ahead inflation expectations of the financial sector were stable

Chart III.6.2 **Indices of the number of issued construction permits for new construction**
(quarterly averages s-a, 2018 = 100)



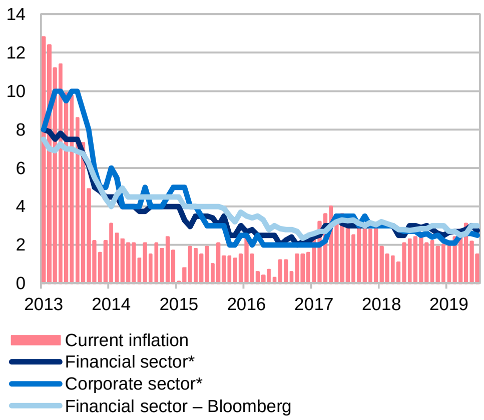
Sources: SORS and NBS calculation.

Chart III.7.1 **One-year ahead inflation expectations of the financial sector**
(y-o-y rates, in %)



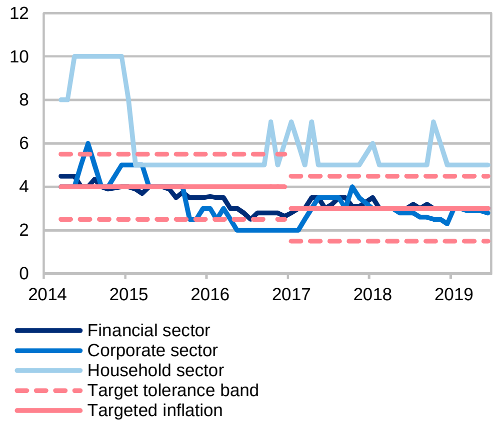
Source: Bloomberg.
* 10-90 percentile range.

Chart III.7.2 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.
* Ipsos and Gallup agencies until December 2014, Ninamedia since December 2014, and Ipsos since January 2018.

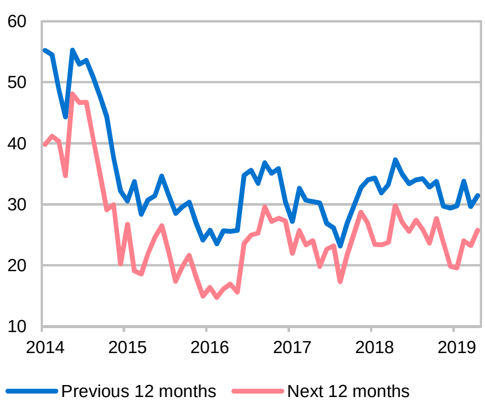
Chart III.7.4 **Two-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Ipsos/Ninamedia and NBS.
* Ipsos until December 2014, Ninamedia since December 2014, and Ipsos since January 2018.

at 2.7% in Q1, while they moved within the range 2.8–3.0% in Q2. The results of the Bloomberg survey point to similar conclusions, stating that the financial sector expects inflation movements to be within the NBS target tolerance band in H1 2020, in the range 2.5–3.0%. Looking at a longer time interval, one-year ahead inflation expectations of the financial sector have been within the NBS target band for almost six years, more precisely since October 2013. **The confidence of the financial sector that price stability will be maintained is also reflected in lower dispersion of individual expectations of financial sector representatives**.

Chart III.7.3 **Inflation perceived and expected by households***
(in index points)



Sources: Ipsos/Ninamedia and NBS.

* Ipsos until December 2014, Ninamedia since December 2014, and Ipsos since January 2018.

The results of the survey conducted by **Ipsos** agency suggest that **one-year ahead inflation expectations of the corporate sector** moved in the lower part of the target tolerance band in H1 – they stood at 2.1% in January and February, most likely due to the slowdown of y-o-y inflation by the end of last year, and as of March stabilised between 2.5 and 2.6%. **Short-term inflation expectations of households** are usually higher compared to other sectors and they moved in the range 5.0–6.0% in H1. At the same time, the results of the qualitative survey of household inflation expectations[26] show that the index of perceived inflation continued to record higher values than the index of expected inflation, indicating that households expect inflation to be lower in the next 12 months than in the past year.

Medium-term inflation expectations of the financial sector are anchored within the NBS target tolerance band since their monitoring began (March 2014), standing at the target midpoint of 3.0% since October last year. **Two-year ahead inflation expectations of the corporate sector** have been declining gradually since the start of the year, from 3.0% in January to 2.8% in June, while **those of households** were stable over H1, standing at 5.0%.

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

8 Fiscal trends

As in the past two years, in 2019 Serbia recorded a consolidated budget surplus, which amounted to RSD 17.3 bn in H1 or 0.7% of estimated GDP. Excluding interest expenses, which rose by RSD 5.8 bn from the same period the year before, primary surplus equalled RSD 87.3 bn in H1, or 3.4% of estimated GDP.

Consolidated revenue increased by 5.1% in real terms in H1, the largest contribution coming from the import VAT (1.7 pp) which can be attributed to the growth in consumption and imports. In addition, revenue from mandatory social insurance contributions also went up (1.7 pp), as did the receipts from income tax (1.3 pp) on account of positive labour market trends, reflected in rising formal employment and wages. Income from corporate profit tax also increased (0.7 pp contribution), owing to higher profitability of domestic companies. On the other hand, even though in March the NBS paid to budget undistributed profit in the nominal amount of RSD 9.3 bn, total non-tax income was lower by 5.6% due to the phased cancellation of the measure pertaining to the obligation of public enterprises to pay funds to the budget.

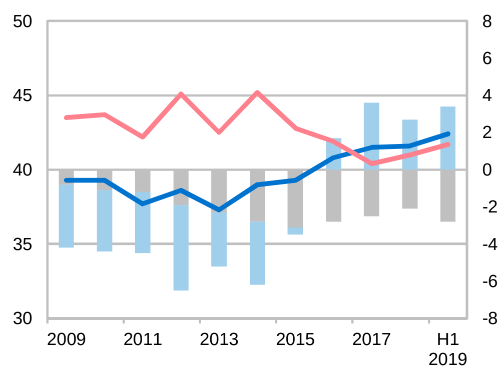
Consolidated expenditure increased by 7.1% in real terms in H1, primarily on account of faster rising capital expenditure, which went up by 27.2% in real terms, giving a 2 pp contribution to the rise in total expenditure. In addition, expenditure went up on account of rising pensions and public sector wages (with the contribution of 1.6 pp and 1.4 pp, respectively) and, to a lesser extent, higher outlays for the purchase of goods and services (0.9 pp) and interest expenses (0.4 pp). On the other hand, called guarantees declined, pushing total expenditure down by 0.4 pp.

Even though the Fiscal Strategy envisages a consolidated budget deficit of 0.5% of GDP in 2019, the developments in H1 suggest that a better than planned fiscal result this year is highly likely.

At end-June **public debt** amounted to EUR 23.55 bn which is 51.4% of projected GDP. The share of public debt in GDP continued declining in 2019. At end-2015 it stood at 75% and by end-2018 it was slashed to 53.8% of GDP.

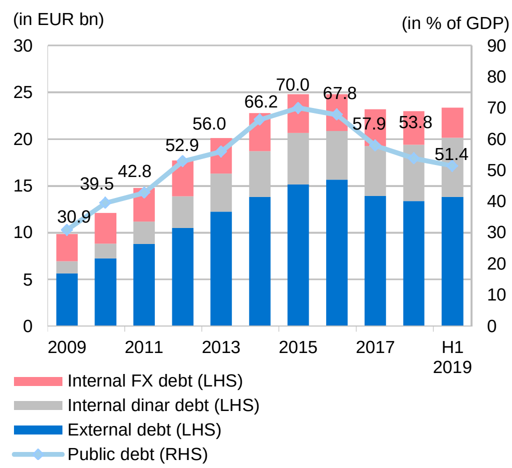
The reduction in the share of public debt in GDP in H1 is entirely attributable to GDP growth (3.5 pp). Currency changes did not affect public debt. In H1 public debt increased nominally by EUR 0.54 bn, 66% of which relating to the issue of dinar government securities. That helped expand the dinar portion of total public debt – by 1 pp, to 27% at end-June.

Chart III.8.1 **Fiscal revenues, expenditures and result**
(in % of GDP)



Source: Ministry of Finance.

Chart III.8.2 **Public debt***



Source: Ministry of Finance.
* Central government.

A ten-year eurobond was issued in euros in the amount of EUR 1.0 bn in June and at the same time there was an early buyback of a part of previously issued eurobonds in dollars maturing in 2020 and 2021 in the same amount, whereby the refinancing risk was diminished. As more expensive securities (coupon rate of 4.875% and 7.25%) were repurchased earlier, **interest expenses in the coming two years will be lower**. The reduction of the dollar portion of debt from 26.5% in 2018 to 22% at end-June **helped mitigate the currency risk**.

9 Aggregate demand

Economic upturn of 2.8% y-o-y in H1 was recorded mostly on account of increasing consumption which can be attributed primarily to the continued positive trends in the labour market. Positive contribution also came from the rising investment, reflected in higher FDI inflow and intensive implementation of infrastructure projects. On the other hand, since imports grew faster than exports, net exports were a negative contributor in H1.

We estimate that economic acceleration can be expected by the end of the year driven, as in H1, by domestic demand and a somewhat faster export growth on account of rising export supply resulting from past investment. Overall in 2019, GDP growth should amount to 3.5%. In the medium term, GDP is expected to accelerate to around 4% on the back of continued positive effect of the said factors.

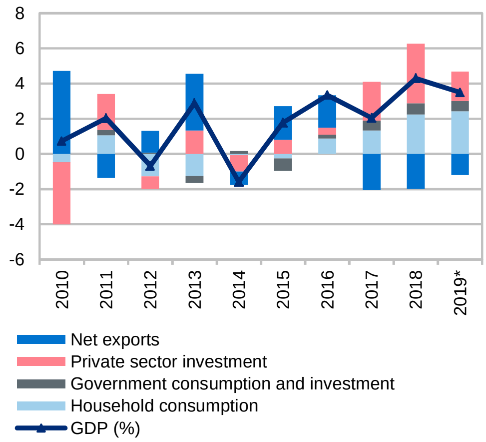
Domestic demand

A sustainable rise in **household consumption** continued into 2019. It amounted to 3.3% y-o-y in H1 (our estimate), contributing 2.2 pp to GDP growth. Higher household consumption is primarily a result of continued positive labour market trends reflected in increased wages and employment. This is also confirmed by the higher wage bill in the private sector by 14.2% y-o-y, as well as expenditure for pensions by 8.3% in H1. On the other hand, net inflow of remittances from abroad contracted by 2.1% y-o-y in H1, while the amount of new loans intended for consumption went down by 6.8% y-o-y, owing to NBS measures aimed at preserving financial stability.

Rising household consumption is also suggested by the main indicators of activity in the service sectors in H1. Real retail trade turnover edged up by 8.1% y-o-y and the number of domestic tourist arrivals and overnight stays by 5.7% and 5.1% y-o-y, respectively.

Government consumption also edged up by 2.5% y-o-y in H1, adding 0.4 pp to GDP growth. The contribution

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



Sources: SORS and NBS calculation.
* NBS estimate.

also came from increased expenses for employees on account of higher public sector wages with the continued trend of employment decline (-0.9% y-o-y). Outlays for the purchase of goods and services also increased in H1.

A positive contribution to GDP growth in H1 (0.5 pp) stemmed from **private investment** which went up by 3.2% y-o-y. The upturn in investment activity of the private sector is primarily indicated by the rise in the import of equipment (12.4% y-o-y), as well as the increase in the production of capital goods (4.0% y-o-y). A greater contribution to GDP growth came from **government investment** (1.1 pp) which is estimated to have grown in value by 33.2% y-o-y in real terms, as indicated by the accelerated implementation of government-financed infrastructure projects.

That overall investment activity is on the rise is also shown by the construction indicators as in H1 the value of executed works went up by 16.1% y-o-y and the production of construction materials by 3.5% y-o-y. A higher number of issued construction permits was also recorded in H1 (4.0% y-o-y), while the envisaged value of works based on those permits more than doubled compared to the same period the year before (102.7% y-o-y), foretelling a certain rise in construction activity in the period ahead.

Further improvement of investment environment and favourable borrowing conditions had a positive impact on financing investment. Namely, corporate profitability increased for the fourth year in a row. In 2018 net profit reached almost RSD 500 bn, while net FDI inflow rose by 27.7% y-o-y, to EUR 1.8 bn in the same period.

Additionally, one part of investment was financed with new investment loans (RSD 134.8 bn excluding refinancing with the same bank), which is a 62.5% y-o-y rise.

Inventories also went up in H1, adding to GDP growth 0.1 pp, in our estimate.

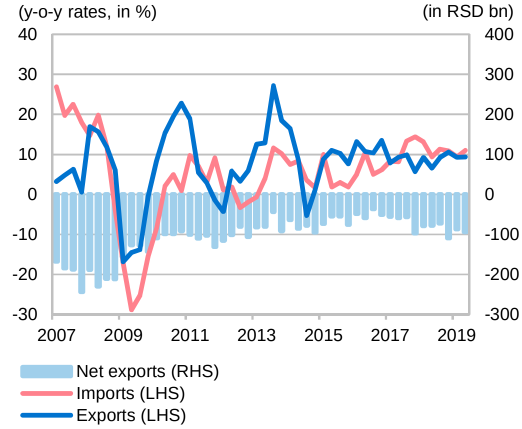
Net external demand

H1 saw a rise in **the export of goods and services** by 9.2% y-o-y in real terms, driven by services, manufacturing and agriculture. Nevertheless, the current investment cycle, and partly also higher energy imports and recovered private consumption accounted for the fact that the real rise in **imports** (10.4% y-o-y) was higher than in exports, which is why the contribution of net exports to GDP stayed negative in H1 (-1.5 pp), as well.

According to the balance of payments data, the export of goods expressed in euros recorded a relatively steep increase (8.5% y-o-y) in H1 despite decelerating external demand and the effect of specific factors such as the EU steel import quotas and taxes on the delivery of goods to Kosovo and Metohija. External trade data suggest that the main contributor to export growth was manufacturing, whose exports accelerated by 5.3% y-o-y in H1. The growth in manufacturing exports remained broad-based (16 out of 23 areas), with the largest contribution from electrical equipment, machinery and equipment, and rubber and plastic products. Set against that, overhauls in the Pančevo oil refinery and Petrohemija dampened the exports of petroleum and chemical products. A negative contribution also came from the motor vehicle exports, though exports of automobile parts and equipment picked up, reaching 14.8% of the total commodity exports in H1 and largely compensating for the lower automobile exports. Thanks to the good season last year, the export of agricultural products continued up in H1 (33.3% y-o-y), largely on account of increased export of cereals.

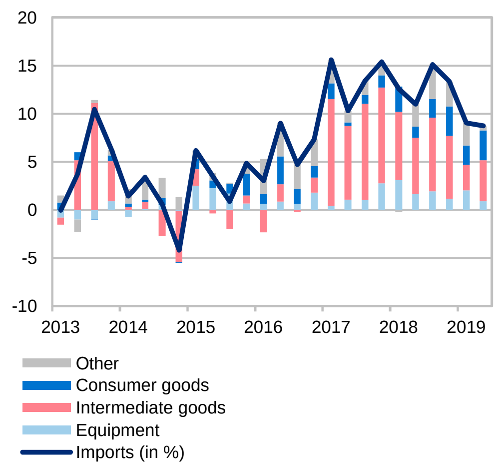
Favourable trends also continued in services exports which sped up by 16.7% y-o-y in H1. As before, the largest contribution to this growth came from the export of information-communication services (30.8% y-o-y) and business services (23.4% y-o-y). Furthermore, the export of transport, tourist and construction services provided significant contributions.

Chart III.9.2 **Exports and imports of goods and services**
(in previous-year constant prices, ref. 2010)



Sources: SORS and NBS calculation.
Note: NBS estimate for Q2 2019.

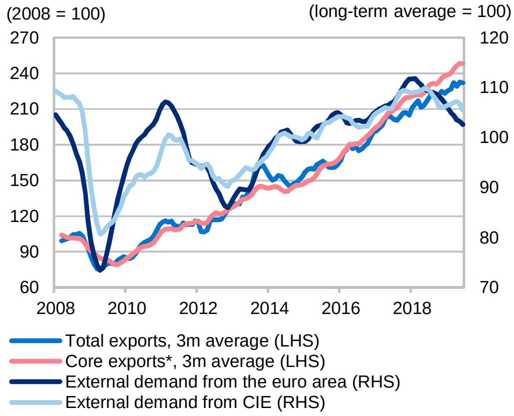
Chart III.9.3 **Movement of key import components**
(contributions to y-o-y growth, in pp)



Sources: SORS and NBS calculation.

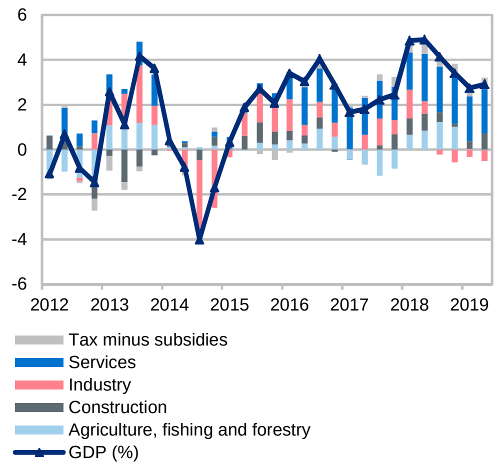
The import of goods expressed in euros rose by 10.2% y-o-y in H1, driven largely by the increased import of intermediate goods (by 6.2% y-o-y) amid growing needs in manufacturing and construction, and partly also by higher energy imports (by EUR 105.6 mn). Consistent with the ongoing investment cycle, equipment imports went up by 12.4% y-o-y, while higher import of consumer goods (by 14.1% y-o-y) indicates a further recovery in household consumption. Similar trends are confirmed by the imports structure according to the EU classification by

Chart III.9.4 **Movement of indicators of external demand for Serbian exports**
(3m moving avarage, s-a)



Sources: European Commission, SORS and NBS.
* Core exports are exports excluding exports of agricultural products, base metals, motor vehicles, petroleum products and electricity.

Chart III.10.1 **Contributions to y-o-y GDP growth rate – production side**
(pp)



Sources: SORS and NBS calculation.

economic destination, which shows that the greatest contributions to imports came from intermediate goods and non-durable consumer goods, followed by energy and, to a lesser extent, also capital goods.

In June 2019, the commodity exports-to-imports ratio measured 73.9%, or 83.2% if services are included, similar as at end-2018. In June, goods exports were 135.0%[27] and imports 39.4% above their pre-crisis levels.

10 Economic activity

The rise in economic activity continued into 2019, amounting to 2.8% y-o-y in H1, in our estimate. The recovery of domestic demand fully determined the GDP growth, driven in H1 by the pick-up in construction and services. On the other hand, after above-average previous season, the agriculture sector stagnated in H1. In addition, industrial production fell in H1 due to slackening external demand, overhaul of plants in oil and chemical industry and taxes introduced on products delivered to Kosovo and Metohija which affected above all the food industry, dragging its output down. Overall in 2019, GDP is forecast to grow 3.5%, given that in addition to the continued rise in services and construction, we also expect industrial production to recover until the end of the year.

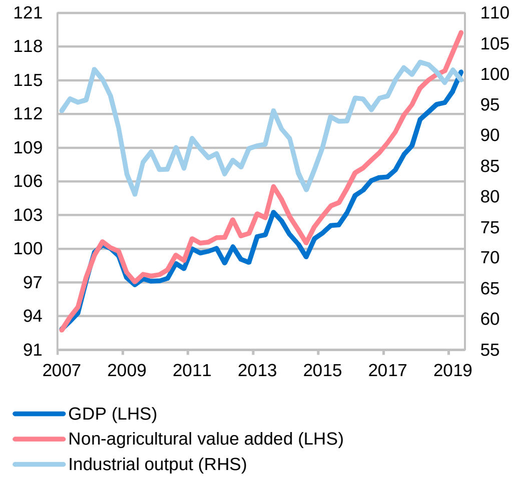
Industrial production dropped by 1.7% y-o-y in H1, with a 0.4 pp negative contribution to GDP growth. The physical volume of industrial production in H1 was lower by 2.0% y-o-y and by 2.8% y-o-y in manufacturing. In addition to reduced external demand, decreased volume of production in manufacturing was a consequence of overhauls in oil and chemical plants where the physical volume of production was cut by 25.6% y-o-y and 17.8% y-o-y, respectively, with a total contribution to the fall in the physical volume of industrial production of 1.9 pp. Taxes on trade in goods in Kosovo and Metohija also pushed down the volume of production of food and beverages, dragging the volume of industrial production by 0.9 pp. On the other hand, 11 out of 24 branches in manufacturing recorded an increase in the volume of production, with the largest positive contribution coming from the production of pharmaceuticals and base metals.

The physical volume of production in mining contracted slightly (0.9% y-o-y) in H1 due to decreased metal ore exploitation. The physical volume of production in electricity, gas and steam supply stayed almost unchanged from H1 2018.

Estimated at 14.1% y-o-y by the Statistical Office (0.5 pp contribution to GDP growth), robust growth in **construction** continued into H1, led by the accelerated implementation of infrastructure projects and recovery of the real estate market. Positive developments in construction are also indicated by the rise in the production of construction materials (3.5% y-o-y) in H1, as well as the increase in the value of executed

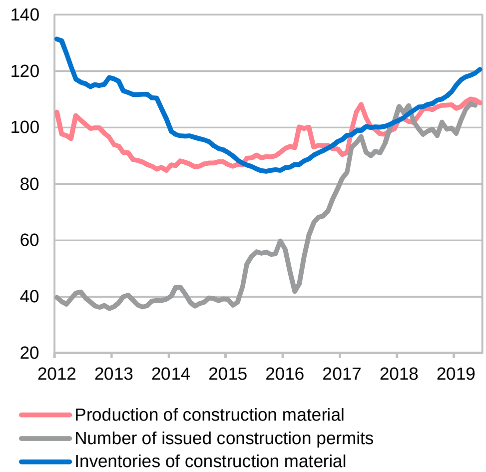
[27] Level from H1 2008.

Chart III.10.2 **Economic activity indicators**
(s-a, H1 2008 = 100)



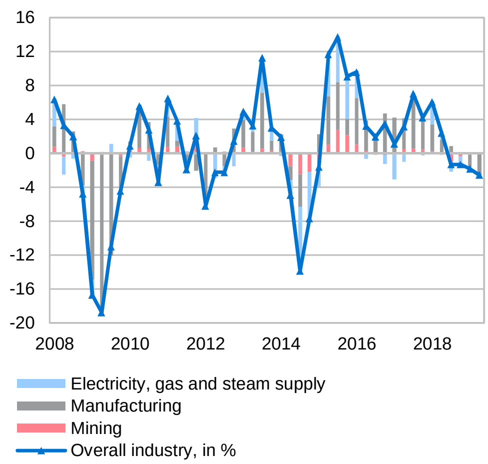
Sources: SORS and NBS calculation.

Chart III.10.4. **Construction activity indicators**
(quarterly averages s-a, 2017 = 100)



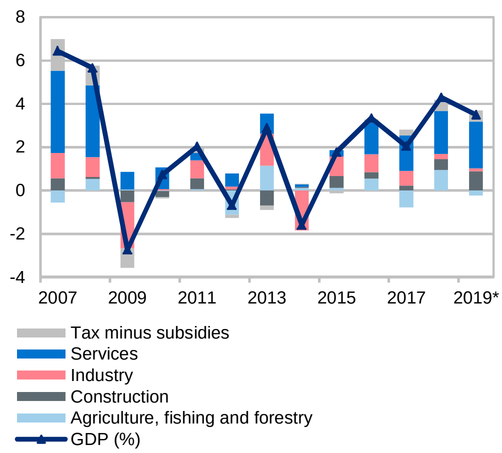
Sources: SORS and NBS calculation.

Chart III.10.3 **Contributions to y-o-y growth of the volume of industrial production**
(in pp)



Sources: SORS and NBS calculation.

Chart III.10.5 **Contributions to annual GDP growth rate – production side**
(pp)



Sources: SORS and NBS calculation.
* NBS estimate.

construction works (16.1% y-o-y). Formal employment in construction also went up (10.1% y-o-y), reaching its highest level since 2012 owing to measures taken to curb the grey economy.

The largest contribution to GDP growth in H1 came from the rising activity in **services** (2.00 pp contribution to GDP growth) which recorded a 3.8% y-o-y increase in the gross value added. This is also confirmed by almost all indicators in the services sector, which recorded growth in H1 on account of recovered domestic demand. Thus, retail trade turnover increased by 8.5% y-o-y in real terms, while turnover in catering grew by 9.2% y-o-y in real terms in the period January–May[28]. The number of tourist arrivals and overnight stays also rose – by 5.3% and 5.8%, respectively from the same period last year.

Even though the past agricultural season recorded above-average results, the Statistical Office estimated that positive trends in **agriculture** continued into H1 2019, as the activity in this sector remained broadly unchanged from H1 2018.

[28] Preliminary data of the Statistical Office.

11 Wages and employment

Since mid-2014 labour market has been continuously recording positive trends which persisted into H1 2019. This relates primarily to the sector-wide increase in average wages and the reduction in the unemployment rate to its lowest level. Though at a somewhat slower pace than in the past two years, total formal employment also continued up, driven by a further economic pick-up.

GDP growth since the beginning of the year has been the main driver of the increase in total nominal net wage, which recorded almost two-digit y-o-y growth in H1 2019 (9.8%), reaching RSD 53,633 or EUR 455 in June. Nominal net wages in the private sector also went up in H1 (10.5% y-o-y), boosted by higher corporate profitability in 2018, as did the public sector wages[29] (9.4% y-o-y), in line with the Government's Decision.

All sectors recorded an increase in the net nominal wage in H1, with the highest absolute and percentile y-o-y rise in information and communication services and mining and energy sectors. Transportation and trade services also recorded higher wages, as did agriculture, manufacturing and construction, as well as financial sector. In addition to industries where the private sector is dominant, wages also rose in public administration, and health and education where the public sector is prevalent.

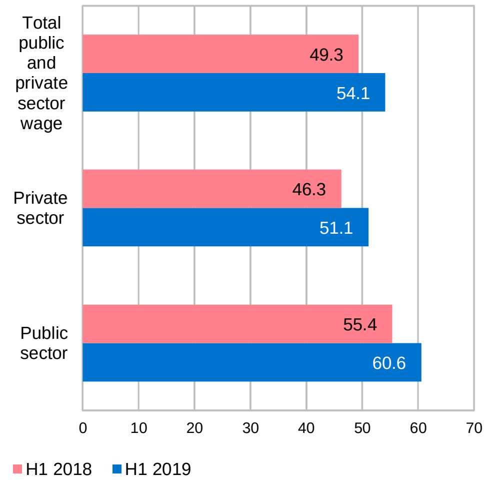
Favourable labour market trends in the past five years translated into a higher total nominal net wage bill, which increased by 14.2% in H1 2019 from the same period a year earlier. At the same time, nominal net wage bill rose both in the private (17.7% y-o-y) and public sector (8.3% y-o-y).

According to preliminary estimates, overall economy productivity increased by 0.7% y-o-y in H1, as a result of a faster growth in GDP than in employment. The rise in productivity in the coming period should be driven by incentives aimed primarily at attracting capital investments and financing projects with greater value added, which in turn intensify job creation.

The results achieved in terms of reducing unemployment cuts and boosting employment account for a mildly softer pace of y-o-y growth rate of overall formal employment in H1, which averaged 2.1%. To this we should also add the relatively high rates of formal

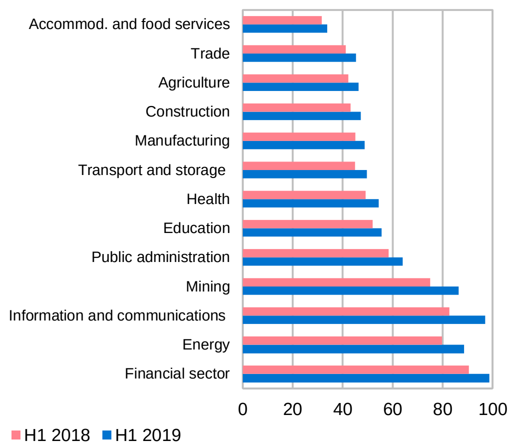
[29] For the purposes of average wage calculation, the Statistical Office classifies the following under the public sector: public enterprises, local public utilities, all levels of administration, public institutions performing health and social protection, educational and cultural activity.

Chart III.11.1 **Average nominal net wage**
(in RSD)



Source: SORS.

Chart III.11.2 **Nominal net wage by economic sector**
(in RSD thousand)



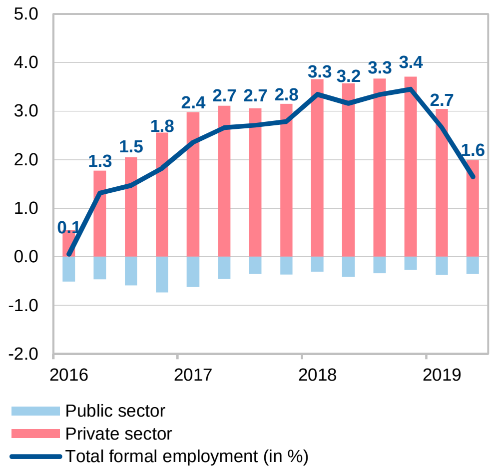
Source: SORS.

Table III.11.1 **Formal employment and unemployment**
(y-o-y growth rates, period average)

	2018		2019	
	Q3	Q4	Q1	Q2
Total number of formally employed	3.3	3.4	2.7	1.6
Employed with legal persons	3.2	3.4	2.6	1.9
Entrepreneurs and their employees	6.7	6.4	5.3	2.8
Individual farmers	-8.2	-8.3	-8.3	-8.7
Unemployed	-10.5	-10.8	-9.1	-9.3
First-time job seekers	-10.9	-11.5	-1.6	21.1
Used to be employed	-10.3	-10.5	-12.7	-24.3

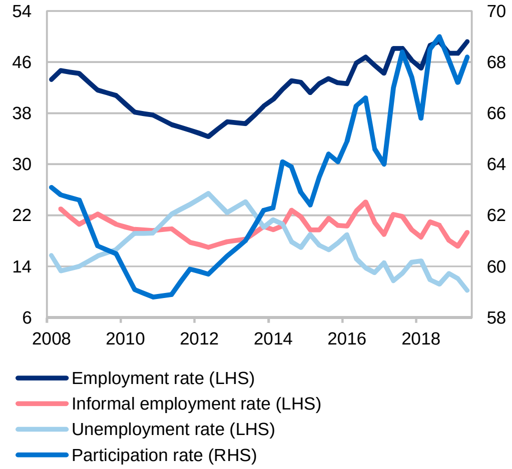
Sources: SORS and National Employment Service.

Chart III.11.3 **Composition of y-o-y growth in formal employment**
(in pp, average for the period)



Sources: SORS and NBS calculation.

Chart III.11.4 **Labour market indicators under the Labour Force Survey**
(in %)



Source: SORS.

employment growth in the previous years. According to Statistical Office data obtained from the Central Registry of Mandatory Social Insurance, **overall employment rose on account of continued employment with legal persons and entrepreneurs**, as opposed to the reduction in the number of individual farmers.

In the period January–June 2019 employment trend in private sector branches continued, primarily in manufacturing, construction, trade and other services. On the other hand, employment cuts were registered in the following sectors: agriculture and energy, as well as health and public administration due to continued public sector right-sizing.[30]

An increase in the number of new recruits was accompanied with a further decline in registered unemployment in H1 amid implementation of ALMPs[31] and improved business investment environment in Serbia. According to the National Employment Service (NES), **H1 recorded a drop in unemployment to a new low** –527,208 people in June, down by 51,864 relative to the same period of 2018. In addition, registered unemployment fell by close to 233,000 people on average in H1 from the same period of 2014. At the same time, unemployment was cut in all occupation groups, mostly in manufacturing, trade, catering and tourism, followed by occupations in agriculture, construction and transportation.

The Labour Force Survey which tracks the informal labour market, too, points to the similar results as the data from the formal sources. In that regard, the participation rate of the working age population (15–64) remained relatively high as in the last year, amounting to 68.2% in Q2 2019. The overall employment rate rose by 0.6 pp in y-o-y terms, to 49.2% in Q2, while at the same time the overall unemployment rate was lowered to 10.3%, and the long-term unemployment rate[32] to 6.1%, which are their lowest levels since comparable data exist. This speaks in favour of the continued reduction in unemployment primarily through the increase in formal employment and a decrease in the share of the informally employed (19.3% in Q2). In Q2 the youth unemployment rate reached its historic low (24.4%), as did the NEET rate (14.1%) – the percentage of young people neither in employment nor in education and training.

Based on the above, we expect that further economic growth and positive business results in the majority of ecoonomic sectors will continue to improve labour market trends in the period ahead of us, primarily through increased wages and employment and reduced unemployment.

[30] Pursuant to the Law Setting the Maximum Number of Employees in the Public Sector.

[31] Active labour market policies entail: job matching services, career guidance and councelling, support to self-employment, further education and training, special programmes for youth in transition from the education system to the labour market, etc.

[32] The long-term unemployment rate is the percentage of people seeking a job for longer than a year in total active population.

List of charts and tables

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