



National Bank of Serbia

2016
February

INFLATION REPORT

2016
February

INFLATION REPORT

NATIONAL BANK OF SERBIA

Belgrade, Kralja Petra 12,

Tel: +381 11 3027-100

Belgrade, Nemanjina 17,

Tel: +381 11 333-8000

www.nbs.rs

Number of copies: 60

ISSN 1820-9394

Introductory note

The *Agreement on Inflation Targeting* between the Government of the Republic of Serbia and the National Bank of Serbia, effective as of 1 January 2009, marks a formal switch of the National Bank of Serbia to inflation targeting as a monetary policy regime. The main principles and operation of the new regime are defined by the *Memorandum on Inflation Targeting as a Monetary Strategy*.

Since one of the underlying principles of inflation targeting is strengthening the transparency of monetary policy and improving the efficiency of communication with the public, the National Bank of Serbia prepares and publishes quarterly *Inflation Reports* as its main communication tool. The Inflation Report provides key economic facts and figures that shape the Executive Board's decisions and underpin activities of the National Bank of Serbia.

The Inflation Report aims to cover information on the current and expected inflation movements and to provide analysis of underlying macroeconomic developments. It also seeks to explain the reasoning behind the Executive Board's decisions and to provide an assessment of monetary policy effectiveness during the previous quarter. Also integral to this Report are the inflation projection for eight quarters ahead, assumptions on which the projection is based and an analysis of key risks to achieving the target.

The information contained in this Report will help raise public understanding of monetary policy implemented by the central bank and awareness of its commitment to achieving the inflation target. It will also play a role in containing inflation expectations, as well as in achieving and maintaining price stability, which is the main statutory task of the National Bank of Serbia.

The February *Inflation Report* was considered and adopted by the NBS Executive Board in its meeting of 11 February 2016.

Earlier issues of the Inflation Report are available on the National Bank of Serbia's website (<http://www.nbs.rs>).

Executive Board of the National Bank of Serbia:

Jorgovanka Tabaković, Governor

Ana Gligorijević, Vice Governor

Veselin Pješčić, Vice Governor

Diana Dragutinović, Vice Governor

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

ABBREVIATIONS

- bln** – billion
- bp** – basis point
- BRICS** – Brasil, Russia, India, China and South Africa
- CPI** – Consumer Price Index
- ECB** – European Central Bank
- EIB** – European Investment Bank
- EMBI** – Emerging Markets Bond Index
- EU** – European Union
- FAO** – UN Food and Agriculture Organization
- FDI** – foreign direct investment
- Fed** – Federal Reserve System
- GDP** – gross domestic product
- H** – half-year
- IFEM** – Interbank Foreign Exchange Market
- IMF** – International Monetary Fund
- LHS** – left hand scale
- mln** – million
- NAVA** – non-agricultural value added
- NBS** – National Bank of Serbia
- NPLs** – non-performing loans
- OFO** – other financial organisation
- OPEC** – Organization of the Petroleum Exporting Countries
- pp** – percentage point
- Q** – quarter
- QE** – quantitative easing
- q-o-q** – quarter-on-quarter
- RHS** – right hand scale
- s-a** – seasonally-adjusted
- SDR** – Special Drawing Right
- SORS** – Statistical Office of the Republic of Serbia
- y-o-y** – year-on-year

Other generally accepted abbreviations are not cited.

Contents

I. Overview	1
II. Monetary policy since the November Report	5
III. Inflation movements	7
<i>Text box 1: Low inflation in Serbia and worldwide</i>	11
<i>Text box 2: Qualitative inflation expectations of households</i>	15
IV. Inflation determinants	17
1. Financial market trends	17
<i>Text box 3: Fall in loan interest rates</i>	20
2. Money and loans	25
3. Real estate market	30
4. Aggregate demand	31
<i>Text box 4: Investment as a driver of GDP growth in 2015</i>	35
5. Economic activity	37
6. Labour market developments	39
7. International environment	42
<i>Text box 5: Current risks from the international environment</i>	49
V. Inflation projection	51
Table A. Indicators of Serbia's external position	63
Table B. Key macroeconomic indicators	64
Index of charts and tables	65
Executive Board meetings and changes in the key policy rate	68
Press releases from NBS Executive Board meetings	69

I. Overview

Inflationary pressures remained rather subdued due to the disinflationary effect of the majority of domestic factors, continuing slide in global prices of oil and primary agricultural commodities, and low inflation abroad, particularly in the euro area which is our major foreign trade partner. Prices inched down quarter-on-quarter, mostly as a result of lower prices of unprocessed food and petroleum products.

Extended period of low inflation and anticipation of low inflationary pressures in the period ahead have helped anchor inflation expectations within the target band. In fact, both one- and two-year ahead inflation expectations of the financial sector and businesses stand below the target (4.0%). The fact that inflation expectations are well-anchored confirms market participants' confidence in the measures taken by the National Bank of Serbia.

Movements in the international environment late last and early this year were marked by weaker global growth prospects due to a probable slowing of growth in some emerging economies, as well as by a continuing slide in global prices of oil and other primary commodities and increased uncertainty in the international financial market. Heightened external risks may also bring into question the pace of recovery of the euro area, where growth is expected to pick up moderately to 1.7% in 2016. Uncertainty in the international financial market increased as market participants responded to the onset of the Federal Reserve's monetary policy normalisation, news of Chinese growth slowdown and fresh turbulences in the Chinese financial market. It is expected that the external risks will be moderated by the European Central Bank's further monetary easing in December and the announced possibility of additional stimulus in March.

The exchange rate of the dinar was relatively stable in 2015. And while appreciation pressures prevailed for most of the year, depreciation pressures built up in late 2015 and early 2016. Depreciation pressures were particularly pronounced in the first half of December, when foreign investors, anticipating the onset of the Federal Reserve's monetary tightening, started reducing their exposure to emerging markets, Serbia included. Foreign exchange demand in the domestic market also increased on account of higher payments for energy imports and dividend payments to foreign owners. These pressures were moderated by an upturn in foreign direct investment, reflecting favourable perception of long-

Inflationary pressures remained rather low in the fourth quarter of 2015.

Market participants expect price stability to be maintained over the coming two years.

Movements in the international environment late last and early this year were marked by weaker global growth prospects, continuing slide in global prices of oil and other primary commodities and heightened uncertainty in the international financial market.

Depreciation pressures intensified late last year, amid heightened uncertainty in the international financial market and increased foreign exchange demand in the domestic market caused by higher payments for energy imports and dividend payments to foreign owners.

After a cut to 4.5% in October 2015, the key policy rate was kept unchanged until February 2016, when it was trimmed further to 4.25%.

Substantial narrowing of fiscal imbalances contributes to the sustainability of Serbia's public finances, while increasing its resilience to external shocks,...

...and went hand in hand with the narrowing of external imbalances.

term investment in Serbia, as well as by the successful completion of the third review under the arrangement with the International Monetary Fund and Serbia's improved credit rating outlook.

As a result of notable monetary easing in 2015, the cost of government and private sector borrowing continued to contract in the fourth quarter, while both household and corporate lending recovered. A hefty rise in new investment loans to corporates indicates that growth in private investment is financed from bank lending to a larger extent than before. In February this year, the key policy rate was trimmed further to 4.25%. Looking ahead, the monetary policy will continue to encourage economic growth through lending activity, to the extent permitted by movements in key factors of inflation and risks stemming mainly from the international environment.

At year level, the budget deficit amounted to 3.7% of GDP, which is significantly below the ceiling under the agreement with the International Monetary Fund. It was almost 3.0 percentage points lower than in 2014, while the primary deficit was only 0.5% of GDP. This represents a very significant economic policy result, as it contributes to the sustainability of Serbia's public finances and enhances its resilience to external shocks. Most of the savings made in 2015 is attributable to cuts in pensions and public sector wages, but also to improved tax collection. Considering that a further reduction in the share of consolidated budget deficit in GDP should rely more on savings resulting from structural adjustments, which initially entail certain costs, we estimate that this share will continue down in the years ahead, but at a slower pace than in 2015.

In 2015, both internal and external imbalances narrowed – current account deficit came at 4.8% of GDP, which is 1.2 percentage points less than in 2014. Also, by contrast to earlier years, the deficit was fully covered by the net inflow of foreign direct investment, which strengthens Serbia's external position. We expect that the current account deficit will narrow further in the years to come, mostly as a result of the recovery of external demand, that is, of the euro area, but also because of a lower share of consumption in GDP under the impact of fiscal consolidation measures, despite the anticipated increase in imports of capital goods. Over the short run, exports will be supported by favourable financial conditions sustained in part by low oil prices, and, over the medium run, by the initiated structural reforms.

The recovery of industrial production and continued favourable movements in the construction industry

prompted a 0.2% seasonally-adjusted GDP growth in the fourth quarter. A fall in agricultural production worked in the opposite direction and is estimated at around 8.0% at year level. Relatively strong GDP growth continued in year-on-year terms as well and, according to the preliminary estimate of the Serbian Statistical Office, came at 1.3%.

According to the estimate of the Serbian Statistical Office, GDP grew by 0.8% in 2015, which is consistent with our November projection. On the production side, a slightly weaker than expected rise in industrial production was offset by a lower than anticipated drop in the services sector. On the expenditure side, private investment rose substantially, and government investment to a smaller extent, though its growth dynamics improved significantly in the second half of the year. Although the recovery of external demand had a positive impact on Serbia’s exports, the contribution of net exports was neutral because the rise in investment pushed up imports of equipment. As expected, final household and government consumption contributed negatively to GDP on account of consistent implementation of fiscal consolidation measures. Still, this effect was weaker than anticipated, as disposable income went up due to lower loan repayment costs, higher foreign remittances and sliding oil prices.

GDP is expected to grow by 1.8% in 2016 and accelerate to around 2.2% in 2017. This growth is expected to be led by investment, while the contribution of net exports will most probably be neutral. However, by contrast to 2015 when household consumption acted as a drag on GDP growth due to fiscal consolidation, this year we expect it to become a positive contributor.

After following a downward path for an extended period of time, year-on-year inflation is projected to rise from mid-2016 and make its way back within the target band late this or early next year. We estimate that its growth will continue in 2017, though at a much slower pace, averaging around 3.0%. Inflation growth will reflect gradual weakening of disinflationary pressures amid expected rise in international primary commodity prices, domestic demand and inflation abroad. The risks to the projected inflation path are mostly associated with external factors, i.e. future developments in the international commodity and financial markets.

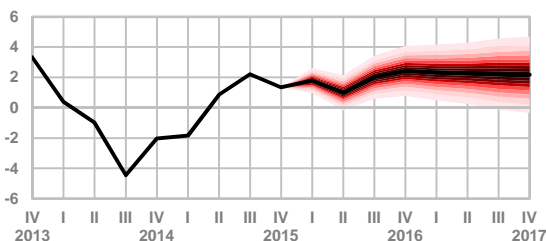
The new inflation projection is lower than the one published in the November Report and the possible outcomes for inflation are symmetrically dispersed around the central projection rate since downside and upside risks in the coming period appear to be balanced.

On the production side, fourth-quarter GDP growth was driven by favourable movements in industry and construction.

Lower operating expenses, continued implementation of infrastructure projects, along with an improved business and investment climate, contributed to the increase in investment as the key driver of GDP growth in 2015.

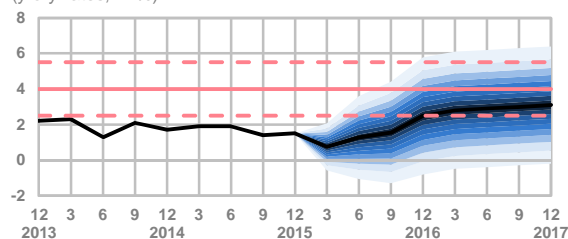
Led by investment, economic growth is expected to accelerate to 1.8% in 2016 and 2.2% in 2017.

GDP growth projection
(y-o-y rates, in %)



According to our latest projection, year-on-year inflation should rise moderately from mid-year and return within the target tolerance band late this or early next year.

Inflation projection
(y-o-y rates, in %)



The new inflation projection is lower than the one published in the November Report, due primarily to the renewed fall in global prices of oil and primary agricultural commodities and the downward revision of the euro area inflation projection.

The monetary policy stance in the period ahead will depend primarily on international developments.

The projected lower inflation is mainly attributable to the renewed decline in global oil prices and the downward revision of their assumed growth during the forecast period. In addition, stronger disinflationary pressures are signalled by the renewed fall in prices of primary agricultural commodities and the expectation of their somewhat weaker growth in the period ahead, as well as by a lower euro area inflation forecast.

As inflationary pressures are likely to stay low in the period ahead, the monetary policy stance of the National Bank of Serbia should remain expansionary. Given the current prevalence of external risks associated with movements in the international financial and commodity markets, the degree of monetary expansion will depend primarily on the assessment of their potential inflationary effect.

II. Monetary policy since the November Report

After falling to 4.5% in October 2015, the key policy rate was kept unchanged until February 2016 when it was trimmed to 4.25%.

Keeping the key policy rate steady was rationalised primarily by the recent monetary policy easing and growing uncertainties in the international environment triggered by the Fed's monetary policy normalisation, upheavals in the Chinese financial market and a slowdown in China's growth.

However, the increasingly certain slowdown in global economic growth and a further decline in the prices of oil and other primary commodities prompted the Executive Board to trim the key policy rate again in February 2016. It is expected that external risks will be mitigated by the ECB's monetary policy, which was additionally relaxed in December and may be accommodated further in March. Also, the pace of normalisation of the Fed's monetary policy is likely to be slower than expected. Restrictive fiscal policy, dampened inflation expectations and relative stability of the exchange rate are expected to contribute to low inflationary pressures.

Since the November *Inflation Report*, y-o-y inflation continued to move below the lower bound of the target tolerance band. Under the projection released at the time, inflation was expected to gradually come closer to the 4.0% target in H2 2016 and stay within the target tolerance band until the end of the projection horizon. Inflation was expected to rise in the short run on the back of last year's low base in terms of the prices of petroleum products and cigarettes, while in the medium run, disinflationary pressures were envisaged to subside in response to a gradual increase in aggregate demand and inflation in the international environment. The risks to the projected inflation path were associated primarily with uncertainty relating to movements in the prices of primary commodities in the international market, level of adjustment of administered prices and economic developments abroad. As for economic activity in Serbia, it was anticipated that GDP would gain 0.8% in 2015 and accelerate to 1.8% in 2016. These growth rates were increased by 0.3 pp relative to the August projection to account for quicker than expected growth in investments.

In consideration of such inflation and GDP projections, and taking into account the new information on developments at home and abroad, the NBS Executive Board **kept the key policy rate unchanged (4.5%) from November 2015 until February 2016**. The Executive Board's decision was taken primarily in consideration of the heightened uncertainty in the international environment, as well as the anticipated effects of past key policy rate cuts and the gradual trimming of the FX reserve requirement ratio on inflation movements in the coming period.

External risks were mostly associated with unpredictability of the reaction of market participants to the Fed's anticipated policy rate increase and its effects on commodity and financial markets, particularly as regards capital flows to emerging economies, including Serbia. In mid-December, the Fed began its policy normalisation process and raised the target range for the policy rate to 0.25–0.50%. Such decision by the Fed was anticipated by markets, though the pace and scope of the

policy rate increase during the course of 2016 remain uncertain, as well as the extent of its impact on capital flows to emerging economies given the concurrent increase in monetary policy easing by the ECB.

A downturn in China's growth and depreciation of its currency fanned instability in the international financial market. Investors across the world became rather susceptible to turbulences in Chinese stock markets, as well as to any news of abated Chinese growth because of its effect on global growth and demand in the primary commodities market. Also, uncertainty in the international environment was additionally stirred by geopolitical tensions, most notably in the Middle East.

Closer to home, the Executive Board estimated that external risks would dissipate owing to the ECB's monetary policy which was loosened further in December, as announced in October. Namely, the ECB decided to extend the quantitative easing programme by another six months, until March 2017, and to trim the deposit facility rate by 0.1 pp to -0.3%, thereby generating a positive effect on global liquidity.

However, the renewed decline in the prices of oil and other primary commodities at end-2015 and early 2016 necessitated a downward revision in those prices for the period ahead and boosted the odds that global inflation will keep running extremely low for some time yet. The slackening of some emerging markets, notably China, which seems increasingly certain, could have negative effects on global demand and economic growth, especially as regards the pace of growth of Serbia's key trade partner – the euro area. Even though the ECB eased its monetary policy in December, already in January it announced the possibility of further accommodation in March. Under such circumstances, the Fed's monetary policy normalisation may proceed at a slower than expected pace.

In consideration of the expected continuation of weaker cost-push and demand-side pressures stemming from the international environment, as well as on account of the majority of domestic factors, the Executive Board **in its February meeting decided to further cut the key policy rate by 0.25 pp to 4.25%**. The Executive Board

also adopted amendments to the Decision on Interest Rates Applied by the NBS, to **narrow the interest rate corridor from $\pm 2.0\%$ to $\pm 1.75\%$ relative to the key policy rate**. The amendments were put through in an effort to contribute to further stabilisation of interest rates in the interbank money market, gradual reduction of the spread between the effective rate and the key policy rate, and strengthening of the interest rate transmission channel.

The Executive Board assessed that y-o-y inflation will rise moderately from mid-year and return within the target tolerance band late this or early next year. Inflation expectations of the financial sector and economy still hover below the 4.0% target for both one and two years ahead. Inflation will also be kept low by tight fiscal policy, relative stability of the dinar, as well as the still low aggregate demand which may yet be further affected by the global slowdown.

The NBS will continue to monitor closely the developments in the international environment and use all instruments on hand to keep inflation low and stable, as this, together with preserving financial stability and a relatively stable exchange rate, is a precondition to accelerated but sustainable economic growth. Moreover, progress in fiscal consolidation and ensuring sustainability of public finances, improvement in the business and investment environment, and the narrowing of external imbalances will be of great assistance in moderating the effect of external shocks.

The NBS expects that the continued monetary easing will lead to a further decline in lending rates and sustained recovery in lending, which will contribute to higher investment.

On grounds of the Executive Board's decision to cut the FX required reserve ratio by 1 pp¹ in each of the six months starting from September 2015, a total of EUR 232 mln and RSD 16 bln were released back to banks in Q4, which helped increase their credit potential. Dinar required reserve ratios were not changed (5% on sources maturing in up to two years and 0% on sources of longer maturities), so as to encourage banks to continue using dinar sources of funding.

¹ Starting from the 2016 February maintenance period, FX required reserve ratios will be 20% and 13%, depending on maturity.

III. Inflation movements

Consistent with expectations presented in the November Inflation Report, y-o-y inflation continued below the lower bound of the target tolerance band in Q4. Inflationary pressures were low because of the disinflationary effect of most domestic factors, falling cost pressures which were caused by the continued drop in the prices of oil and primary agricultural commodities in the global market, and generally low inflation in the international environment, particularly in the euro area, our most important foreign trade partner. Prices declined at the quarterly level, which, broken down by component, is a consequence of falling unprocessed food and petroleum product prices (broken down by component).

The inflation expectations survey indicates that all sectors expect prices to remain stable in the following two years. As regards the financial and corporate sectors, both one- and two-year ahead inflation expectations are within the target band. Anchored inflation expectations reflect the confidence of market participants in the measures undertaken by the NBS.

Inflation movements in Q4

Inflationary pressures remained subdued in Q4, both on account of the majority of domestic factors and low primary commodity prices in the global market amid a generally low inflation environment worldwide. The same factors led to low price growth throughout the year – y-o-y inflation rate averaged 1.4%² in 2015, and was driven primarily by the electricity and cigarette price rise.

Consistent with expectations presented in the November Inflation Report, y-o-y inflation stayed below the lower bound of the target tolerance band in Q4. It measured 1.5% in December. The contribution of food prices to y-o-y inflation continued down to become neutral in December, chiefly due to a strong drop in unprocessed food prices. A drag on y-o-y inflation also came from petroleum product prices (contribution: –0.3 pp in December), mirroring a further drop in global oil prices in Q4. Conversely, higher administered prices contributed positively to y-o-y inflation, notably the price increases of

Table III.0.1 Consumer price growth by component
(quarterly rates, in %)

	Share in CPI	2015			
		I	II	III	IV
Consumer prices (CPI)	100.0	1.4	0.7	-0.1	-0.5
Unprocessed food	12.0	8.6	-0.2	-6.3	-5.9
Processed food	20.8	1.7	0.3	0.9	-0.3
Industrial products excluding food and energy	28.5	-0.1	0.9	0.5	1.7
Energy	15.4	0.7	0.7	2.2	-2.0
Services	23.3	-0.5	1.5	0.4	0.7
Core inflation indicators					
CPI excluding energy	84.6	1.5	0.7	-0.5	-0.2
CPI excluding energy and unprocessed food	72.7	0.3	0.9	0.6	0.8
CPI excluding energy, food, alcohol and cigarettes	44.5	-0.5	1.0	0.2	0.9
Administered prices	19.8	-0.1	0.8	3.7	1.0

Sources: SORS and NBS calculation.

² According to data of the Serbian Statistical Office, the average annual inflation rate in 2015 was somewhat higher – 1.9%.

Chart III.0.1 Price movements
(y-o-y rates, in %)

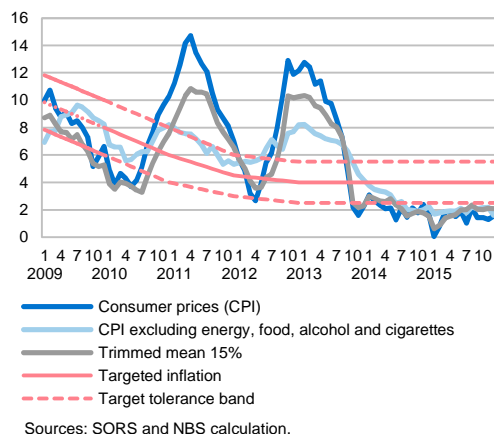


Chart III.0.2 Contribution to y-o-y consumer price growth
(in pp)

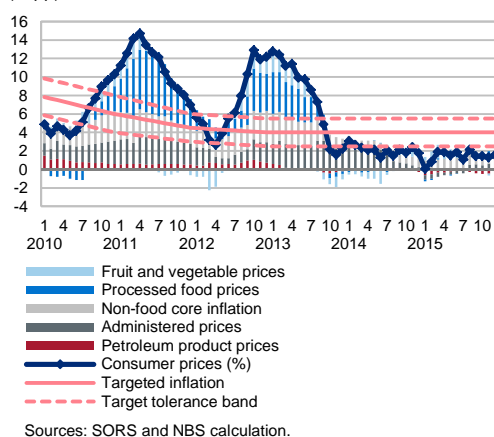
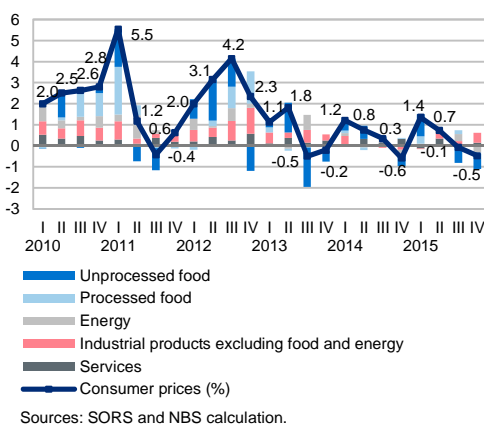


Chart III.0.3 Contribution to quarterly consumer price growth
(in pp)



electricity in August and cigarettes in December, (each contributing 0.6 pp in December).

Despite the expectations expressed in the November Inflation Report that consumer prices would increase slightly in quarterly terms, they decreased in Q4 (0.5%). This was primarily caused by the greater than expected drop in unprocessed food and petroleum product prices.

The contribution of **prices of food and non-alcoholic beverages** remained negative in Q4 (-0.8 pp). The drop in **unprocessed food** prices (5.9%, contribution: -0.7 pp) was driven by the prices of fruit (-30.9%, contribution: -0.8 pp). In general, fruit prices tend to go down in Q4, but the decline this year was sharper (around 25%). Lower fresh meat prices acted in the same direction, though somewhat less intensely (7.5%, contribution: -0.3 pp). On the other hand, vegetable prices rose (10.1%, contribution: 0.4 pp). A minor drop was recorded by prices of **processed food** (0.3%, contribution: -0.1 pp), since the prices of milk, dairy products and meat products shrank.

Petroleum product prices in the domestic market continued down in Q4 (5.3%, contribution: -0.3 pp), reflecting the plunging world oil prices. In December, petroleum product prices were some 6% lower than a year earlier. Declining prices of these products and natural gas (9.1%) pushed down prices within the **energy** group (2.0%, contribution: -0.3 pp).

Industrial product prices excluding food and energy picked up by 1.7% in Q4 (contribution: 0.5 pp), predominantly on the back of the December cigarette price rise (4.9%), caused partly by the expected January increase in excise duties, and rising prices of pharmaceuticals (2.9%). These prices, though to a lesser degree, were also pushed up by the seasonal increase in prices of clothing and footwear. Generally speaking, relative stability of the dinar and muted domestic demand limit price growth in this group.

Services prices were also slightly up in Q4 (0.7%, contribution: 0.2 pp). Within this group, prices of travel packages rose, as did the prices of apartment rental services, albeit more mildly, while prices of transport services declined. Prices of other services edged up marginally, notably due to the persistently subdued domestic demand.

Core inflation (measured by CPI excluding prices of energy, food, alcohol and cigarettes) arrived at 0.9% in Q4. A positive impulse came primarily from the prices of

travel packages and pharmaceuticals, but also from the prices of mobile phones, automobiles, clothing and footwear. Y-o-y, core inflation has been below the lower bound of the target tolerance band since August 2014. It measured 1.6% in December 2015.

Administered price growth in Q4 (1.0%, contribution: 0.2 pp) was considerably below that in Q3, and was chiefly driven by a rise in cigarette prices, whilst a reduction in the prices of natural gas, utilities and passenger transport worked in the opposite direction. In 2015, administered prices grew 5.5%.

Producer and external prices

Industrial producer prices in the domestic market rose slightly (0.2%) in Q4. The growth was mostly driven by the petroleum product manufacturers, whose prices increased by 7.6% (contribution: 0.3 pp), and tobacco product manufacturers, whose prices rose by 10.3% (contribution: 0.2 pp). On the other hand, the strongest producer price fall was observed in beverage production and mining (5.2% and 3.1%, respectively). As regards mining, the decline was the steepest in the exploitation of crude oil and natural gas (17.3%), while it was also posted in the exploitation of metal ores, which can probably be linked to the movement of the prices of oil and other primary commodities in the world market.

In terms of purpose, producer prices of energy and intermediate goods inched up in Q4, whilst producer prices of capital goods and durable and non-durable consumer goods remained unchanged.

Producer prices of industrial products for the domestic market edged up in Q4 in y-o-y terms as well, by 0.7% in December.

Following a rise in Q3, **agricultural producer prices**³ dropped in Q4 (8.4%), led by falling prices of cattle and industrial plants, whereas the prices of livestock products rose. In y-o-y terms, growth in agricultural producer prices, after entering into the positive zone in September, decelerated in the months that followed, and started declining again in December (2.2%).

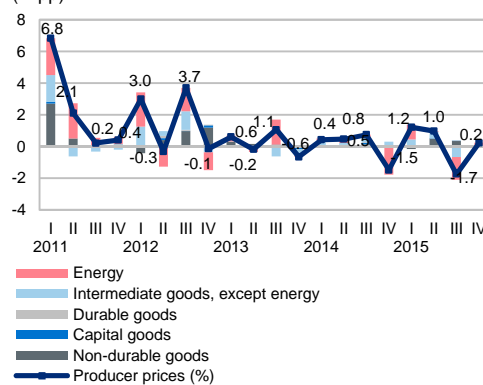
Deflationary cost pressures also continued in construction in Q4, given that the **prices of elements**

Table III.0.2 Price growth indicators
(y-o-y rates, in %)

	2015			
	March	June	Sep.	Dec.
Consumer prices	1.9	1.9	1.4	1.5
Domestic industrial producer prices	0.7	1.2	-1.2	0.7
Agricultural producer prices	-3.0	-5.8	5.8	-2.2
Prices of elements and materials incorporated in construction	0.7	1.0	-1.7	-1.6

Sources: SORS and NBS calculation.

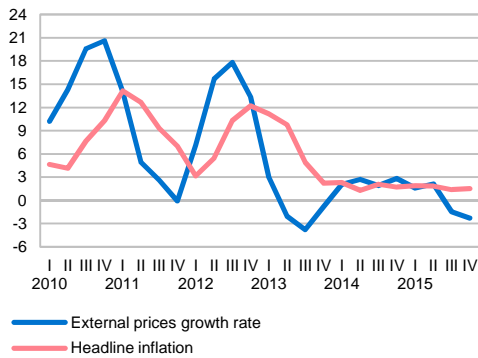
Chart III.0.4 Contribution to quarterly producer price growth
(in pp)



Sources: SORS and NBS calculation.

³ Producer prices in agricultural and fishing sectors.

Chart III.0.5 Domestic inflation and external prices
(y-o-y rates, in %)



Sources: Destatis, FAO, Bloomberg and NBS calculation.

and materials incorporated in construction were down by 0.2% in quarterly terms. At y-o-y level, the fall in these prices was slightly softer than in Q3, coming at 1.6% in December.

Global oil prices continued down in Q4 and, like throughout 2015, had the strongest impact on the movement of **external prices** which, **denominated in euros**, declined by 1.0%. Furthermore, a decline was observed for German export prices, which are used to approximate external prices of intermediate goods and equipment. Still, the nominal depreciation of the dinar against the euro in Q4 resulted in slightly higher **dinar-denominated external prices** (0.3%). In yearly terms, external prices continued falling – by 2.3% in December.

Text box 1: Low inflation in Serbia and worldwide

An important source of the current low inflation in Serbia and worldwide is the sharp plunge in the prices of primary commodities, most notably oil, in international markets. Between June 2014 and February 2016, oil prices slumped by more than 70%, primarily in response to dampened demand caused by slow global recovery, but also due to excess supply. Relaxation of monetary policies in the previous period, primarily by the Fed and the ECB, through both conventional and unconventional measures, has helped increase global liquidity, though global prices have remained low.

Serbia's is an open economy, and low prices in the international market are mirrored in movements of domestic prices. About a third of goods and services provided in Serbia comes from imports which creates a direct channel of influence on local prices. In addition, the fall in global prices has numerous indirect channels of influence on inflation, mostly through production costs, the balance of payments and final consumption. The current global low inflation environment and low prices of oil and other primary commodities in international markets have enabled, inter alia, a continuation of monetary policy easing at a much brisker pace in 2015.

For two straight years, inflation in Serbia has been running low and stable at around 2% y-o-y. It is extremely low in many other countries as well, both developed economies and emerging markets. In 29 of the 45 European countries, including 19 euro-area members, the y-o-y inflation in December 2015 was below 1%, while 15 European countries recorded negative inflation rates. On the other hand, high inflation rates recorded in some countries were mostly driven by depreciation of national currencies as a result of their exposure to geopolitical tensions, macroeconomic imbalances and the volatility in capital flows. Six European countries (including Russia and Turkey) registered inflation rates above 5%.

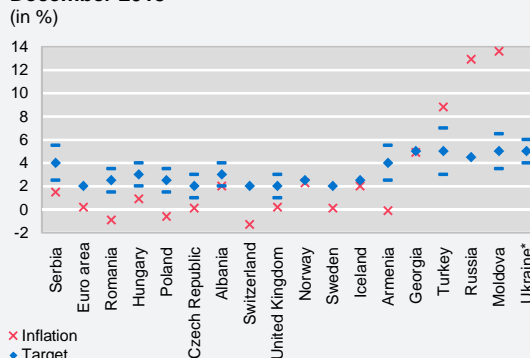
Since March 2014, inflation in Serbia has moved below the lower bound of the target tolerance band of $4 \pm 1.5\%$ as a consequence of low inflation in the international environment. Of the 36 European countries endeavouring to achieve inflation target, including 19 countries of the euro-area, the number of those with inflation running below the target has been rising over the past years. In early 2011, only five countries undershot the inflation target, whereas at the beginning of 2014 this number reached 30 and stayed in that region until end-2015.¹ In December 2015, of the 36 European countries striving to achieve inflation targets, Serbia included, 30 recorded below-the-target inflation rates.

Chart O.1.1 Number of European countries with inflation running below the target, of total 36 inflation-targeters



Sources: EUROSTAT and websites of central banks.

Chart O.1.2 Inflation and the target by country in December 2015



* Inflation in Ukraine is not shown in the chart (43.3%).
Sources: EUROSTAT and websites of central banks.

¹ Deviations were calculated relative to the lower bound of the target tolerance band, and if the inflation target is defined as a point value, deviation is any difference higher than 0.1 pp.

Another fall in the prices of oil and other primary commodities that occurred in late 2015 and early 2016 increased the odds that global inflation will remain exceptionally low for some time to come. This is one of the main reasons why the NBS revised its inflation projection downwards relative to that from the November 2015 Inflation Report. Heightened uncertainty over future movements in the global oil and primary commodities market will be an important factor to take into account when making monetary policy decisions and keeping inflation within the target tolerance band in the medium-run. Still, due to the improved external position of Serbia, aided by fiscal consolidation and structural reforms, the effects of external shocks to the domestic economy will be diminished, and the efficiency of macroeconomic policy measures increased.

Inflation expectations

Owing to low actual inflation and expected low inflationary pressures, all sectors expect that both one-year ahead and medium-term inflation will be within the target tolerance band set by the NBS. Anchored inflation expectations confirm the confidence of market participants in the measures undertaken by the NBS.

In recent months, **one-year ahead** financial sector expectations have ranged between 3.2% and 3.7%, according to the **Bloomberg** survey. The latest available data indicate that the financial sector expects y-o-y inflation to measure 3.4% in February 2017. Financial sector expectations have been within the target band for around two and a half years. Judging by the **Ninamedia**⁴ survey, financial sector expectations are somewhat lower – moving between 2.5% and 3.0% in recent months, and standing at 2.7% in January.

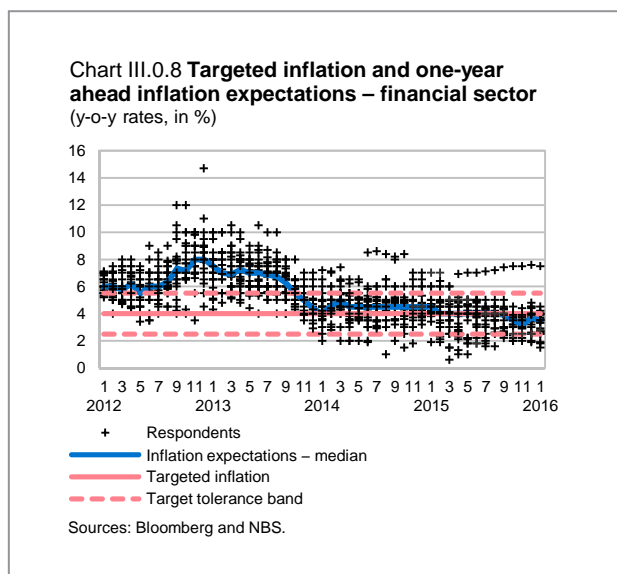
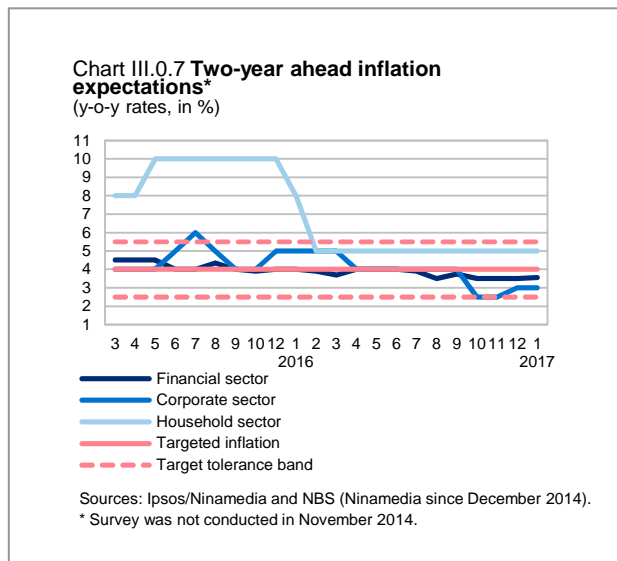
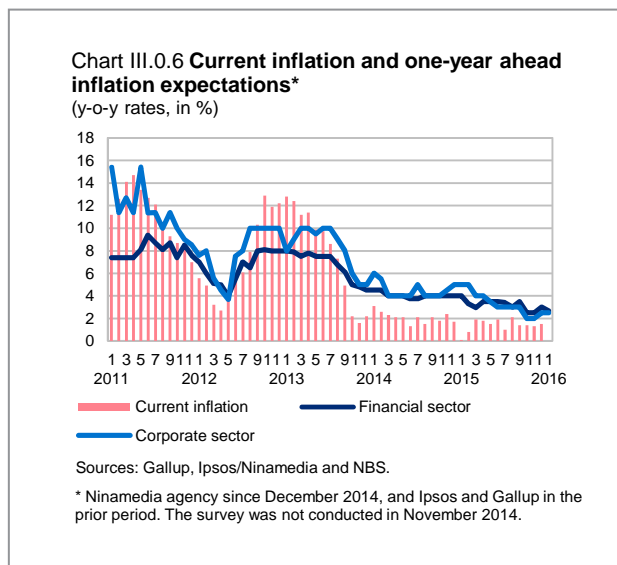
In recent months, inflation expectations of the corporate sector were the lowest. In October and November, they fell to 2.0%, i.e. below the lower bound of the target band, and have stood at the lower bound of 2.5% since December.

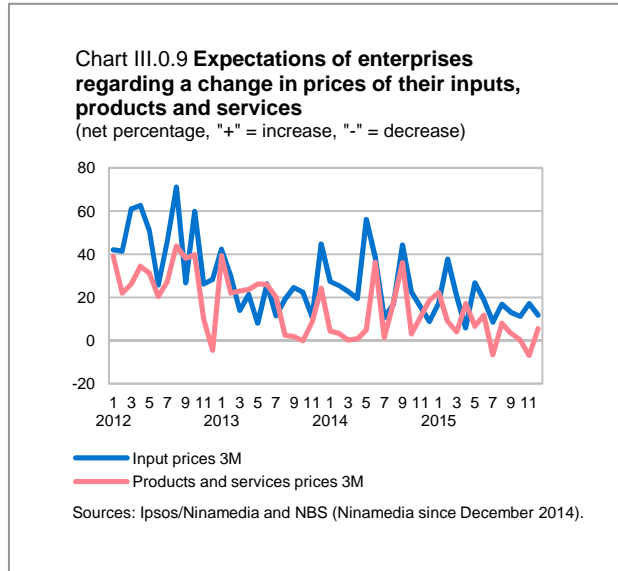
Although they are usually higher, inflation expectations of households have also stabilised within the target tolerance band. They fell to 5.0% in October and have not changed since. According to the results of qualitative household expectations⁵, the part of households which perceives prices to have increased in the previous 12 months does not expect this trend to continue in the following 12 months. After rising in August, the indicator of expected inflation declined, most probably because of the electricity price increase, which points to the reduction in the number of survey participants who expect prices to grow, and the rise in the number of those who expect prices to stabilise or fall.

Medium-term inflation expectations of all sectors have been relatively stable, moving within the target band for around a year. For several months now, two-year ahead financial sector expectations have stood at around 3.5%. Medium-term household expectations are higher, having been stable at 5.0%, i.e. within the target band, since last February. Corporate expectations are the lowest in this respect as well, falling to the lower bound of the target tolerance band (2.5%) in October and November, and standing at 3.0% in December and January.

⁴ Ninamedia clipping d.o.o. Novi Sad has been conducting a survey on expectations of economic entities since December 2014.

⁵ See Text box 2, page 15.





The dispersion of financial sector responses, which is still the lowest compared to other sectors, remains relatively stable both according to Bloomberg and Ninamedia surveys. The dispersion of corporate sector responses narrowed further in the absence of major inflationary pressures. The dispersion of household sector responses, after growing in September, was relatively stable for quite some time, most probably due to the August electricity price rise.

The net percentage⁶ of enterprises expecting their input prices to grow in the next three months continued to decline in Q4 – to 11.9%, most probably because of the falling oil prices, while the net percentage of enterprises expecting an increase in prices of their products grew to 5.6%. Owing to the achieved macroeconomic stability, enterprises expecting their input prices to stay the same are still dominant (85.6%), as are those expecting their product prices to remain unchanged (87.2%).

⁶ The difference between the percentage of enterprises expecting an increase and those expecting a reduction in prices of their inputs, products and services. To increase representation, data are weighted by operating revenue.

Text box 2: Qualitative inflation expectations of households

Inflation expectations are crucial for decision making of economic agents in all markets – markets of goods, labour, money, capital. However, it is hard to collect information on expected price movements because inflation expectations are not directly measurable, in contrast to interest rates, monetary aggregates, the unemployment rate etc. Aware of the importance of inflation expectations, central banks use various approaches nowadays to measure them as accurately as possible.

An obvious approach to the measurement of inflation expectations is to ask economic agents what inflation they expect in the coming period, and this is exactly what central banks do. At the monthly level, all sectors of the economy are surveyed: the financial sector, corporates, trade unions and households. Since January 2009, when it officially adopted the inflation targeting regime, the NBS has been monitoring and analysing inflation expectations, by carrying out a quantitative survey in the said sectors.

However, household inflation expectations are a particular challenge for central banks in general and the NBS is no exception in this respect. Compared to other sectors that are generally better informed about macroeconomic developments, households as a rule report higher quantitative inflation expectations with the greatest dispersion. A change in the country's general price level is a macroeconomic variable which is not easy to predict or even understand, particularly by households. Households are less motivated and do not have the capacity to undertake costly data collection efforts and complex analyses necessary for adequate inflation forecasting. The weaker performance of the quantitative survey of households may also be ascribed to the fact that the respondents' consumer baskets differ and are not necessarily identical to the one used as the country's official statistical measure of the consumer price index.

To assess inflation expectations of households more reliably, the NBS introduced another approach in line with best international practice¹ – a survey of households requiring their qualitative assessment of past and future inflation. The survey has been carried out once a month – since March 2014, on the sample of 1,050 citizens. Respondents are asked how, in their opinion, consumer prices moved in the past twelve months and how they expect them to move in the coming twelve months. Six responses are offered:

- 1) increase considerably (AA);
- 2) increase moderately (A);
- 3) increase somewhat (O);
- 4) remain unchanged (B);
- 5) decrease (BB);
- 6) don't know (N).

To obtain aggregate measures (the indicators of perceived and expected inflation), household responses are quantified as follows:

$$I = (AA + 0,5A) - (0,5B + BB)$$

A difference is made in terms of the intensity of responses – extreme and moderate responses are assigned numerical values of 1 and 0.5 respectively. Theoretically, the indicator may move from 100 (if everybody expects prices to increase considerably) to -100 (if everybody expects prices to decrease). At the same time, the indicator of perceived inflation (previous 12 months) represents the difference between the weighted share of respondents who assess that prices increased more than somewhat and those assessing that prices did not increase (but remained unchanged or decreased). The similar

¹ These indicators are collected in EU countries, as part of the European Commission's Business and Consumer Survey.

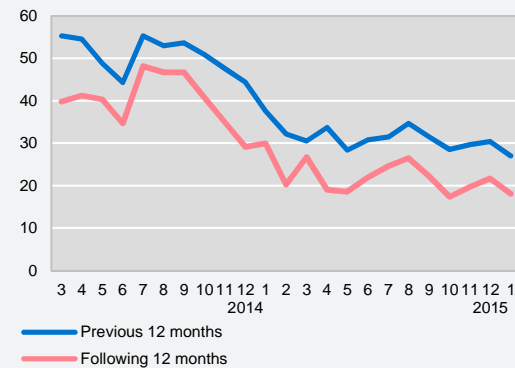
goes for the indicator of expected inflation, which represents the difference between the weighted share of respondents expecting one-year ahead prices to be more than somewhat higher and those expecting prices to remain unchanged or to decrease. Based on this indicator and by comparing it with perceived inflation, it is possible to assess if the number of households expecting higher inflation is rising.

Chart O.2.1 shows the time series of indicators of perceived and expected inflation of households in Serbia. We can observe that both perceived and expected inflation were declining from mid-2014 to mid-2015 (by almost 30 index points). Since then, both have been relatively stable at a much lower level.

However, given that actual inflation has been exceptionally low for quite some time already, households' perceived inflation, albeit significantly lower, remains overestimated. Still, perceived inflation is higher than the expected inflation, which signals that one part of the population, who feel that prices increased in the past twelve months, do not expect the trend to continue, but rather to see prices stabilise or fall. Such expectations reflect low and stable inflation and credible monetary policy implemented by the NBS.

Chart O.2.1 Perceived and expected inflation of households

(in index points)



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

IV. Inflation determinants

1. Financial market trends

Thanks to monetary policy easing, Q4 saw a further decline in money market rates and costs of government and private sector borrowing.

Throughout 2015 the dinar exchange rate was relatively stable. While appreciation pressures dominated for the greater part of the year, in late 2015 and early 2016 the dinar experienced pressures in the opposite direction. Depreciation pressures were most pronounced in early December, when expectations of the Fed's monetary tightening prompted foreign investors to reduce their exposure to emerging markets, Serbia being one of them. These pressures were alleviated by FDI growth, testifying to a favourable investor perception about the long-term investment in Serbia, as well as by the successful completion of the third review under the arrangement with the IMF and improvement in Serbia's credit rating outlook.

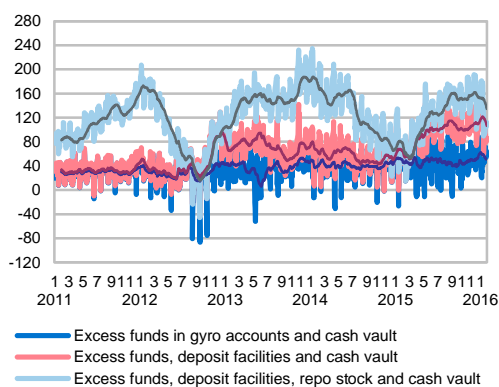
Interest rates

The key policy rate cut fully reflected on a decline in the average repo rate⁷, which amounted to 2.6% in late December, down by 0.5 pp relative to September. Throughout the period under review, the repo rate was almost equal to the deposit facilities rate.

Despite a mild q-o-q increase, trading volumes in the interbank overnight money market remained relatively low in Q4. Average daily trading volumes amounted to RSD 1.7 bln, up by RSD 0.2 bln from Q3. High liquidity in this market was also signalled by BEONIA, which trended close to the deposit facilities rate throughout Q4. BEONIA averaged 2.6% in December, down by 1.0 pp compared to its average September value.

BELIBOR rates also experienced a decline in Q4. The fall was somewhat sharper for longer maturities, aided by the expected low inflation. In December, these rates averaged between 3.1% for the shortest and 4.1% for six-month

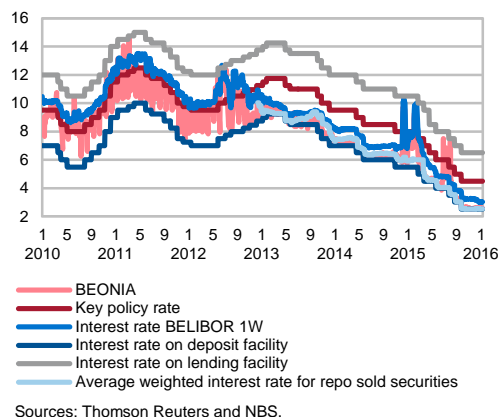
Chart IV.1.1 Dinar liquidity
(daily stock and moving averages, in RSD bln)



Source: NBS.

⁷ Rate recorded at repo auctions weighted by the amount of sold securities.

Chart IV.1.2 Interest rate movements
(daily data, p.a., in %)



maturity, down between 0.7 pp and 0.9 pp relative to September.

In January, trading volumes in the overnight money market increased, while interbank money market rates declined further.

Continued monetary easing and significantly improved fiscal and external position of Serbia brought about a further decline in rates at auctions of dinar government securities in Q4. Rates on these securities ranged between 2.9% for three-month and 6.5% for five-year securities, pushing the dinar yield curve in late 2015 to its new historical low. Compared to auctions held in Q3, those rates dropped between 0.9 pp and 1.8 pp. The rate on five-year securities slid by 4.3 pp relative to the previous auction held in August 2014, mostly on the back of the key policy rate cut of 4.0 pp. This was the only auction of dinar securities in Q4 that attracted foreign investors ahead of the FED's decision on interest rate hike. At the auction of two-year amortising bonds at a variable coupon linked to the key policy rate, the fixed margin narrowed down further (by 0.3 pp to 0.6%).

The rates on dinar government securities at January auctions were almost unchanged from end-2015.

Though softer than for dinar securities, a decline was noted for rates of auctioned government euro securities. Rates on one-year securities remained broadly flat, while rates for other maturities declined between 0.1 pp and 0.4 pp relative to Q3, moving in the range from 1.6% for one-year to 4.4% for ten-year securities in late 2015. Foreign investor participation in primary trade of these securities was modest.

Chart IV.1.3 Yield curve in the interbank money market
(average values, p.a., in %)

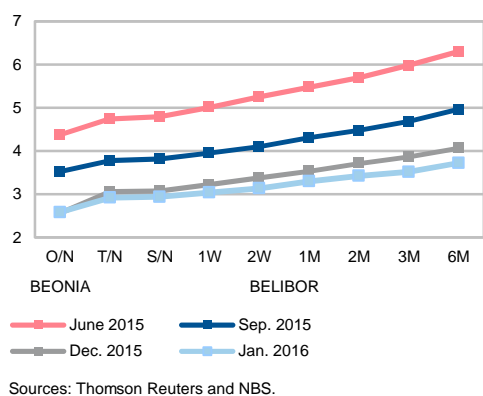
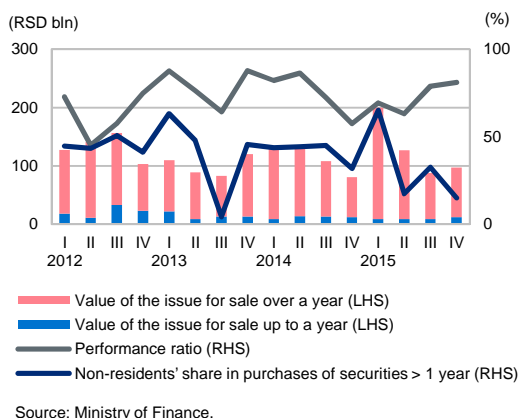


Chart IV.1.4 Primary market of government dinar securities – performance ratio and foreign investor participation



Foreign investors were more active in the secondary market of government securities. They participated mostly on the sale side, which boosted the trading volumes. Total trading volumes expanded by almost 60% to RSD 103.9 bln, and most traded were bonds with initial maturity of three and seven years. Rates of return mirrored the decline of rates in the primary market, ranging from 2.9% for the remaining two-month to 7.5% for the remaining 73-month maturity in December.

More intensive monetary policy easing in 2015 was the key factor behind a further decline in lending rates in Q4. By the year-end, rates on newly approved dinar corporate and household loans fell to their lowest level on record.

The weighted average rate on dinar corporate and household loans has been single digit since November. It

dropped by 2.9 pp in Q4, to 8.8% in December. Household loan rates experienced a sharper fall relative to September – on average by 2.6 pp to 12.1%, while corporate loan rates dropped by 2.1 pp to 6.2%. The average price of dinar loans to households dropped down mainly due to the cutdown in interest rates on cash loans – by 3.1 pp to 12.1%. The price of apartment renovation loans was lowered to 6.7%, while consumer and other loans cheapened to 11.0% and 12.0%, respectively. Rates on all types of corporate dinar loans were on a decline, most pronouncedly on current assets loans (by 2.3 pp to 6.1%). A similar fall in rates (2.2 pp) was recorded for other loans, to 6.4%, while the price of investment loans fell less sharply, to 7.2% in December.

The cost of euro and euro-indexed lending also declined, though to a lesser extent than the cost of dinar lending. The weighted average rate on new euro and euro-indexed dinar loans fell by 0.3 pp to 4.4% in December. Average rates on corporate loans fell by the same amount, to 4.2% in December, while the price of household loans changed negligibly, to 5.9%. In regard to FX-indexed corporate loans, rates on investment loans dropped down the most (by 0.4 pp to 4.4%), reaching the price of current assets loans, while rates on other loans declined to 3.6%. Same as for dinar loans, the greatest rate decline in household loans was recorded for cash loans (by 1.8 pp to 5.3%). Rates on other types of loans also declined in December, ranging from 3.8% for household to 7.9% for other loans.

Judging by the bank lending survey, lower cost of funding and greater competition among banks were the main factors behind the easing of lending terms. The decline was steeper for rates on new dinar deposits, which fell on average by 0.9 pp to 3.1% in December. Average rates on dinar corporate and household deposits fell by the same amount and equalled 3.0% and 4.2% respectively. Average weighted interest rate on new euro deposits at year-end remained unchanged from September (0.8%), as rates on new corporate deposits dropped by 0.1 pp to 0.6%, while rates on household savings upped from 1.0% to 1.1%. Same as in the previous two years, banks offered no incentives on the World Savings Day, so there was no noticeable increase in household savings rates in this period.

In Q4, lending rates declined more than deposit rates, triggering a fall in both dinar and euro interest margins. Since the difference in the decline of dinar rates was somewhat more pronounced, the fall in the dinar interest margin was sharper.

Chart IV.1.5. Interest rates in the primary market of government securities
(p.a., in %)

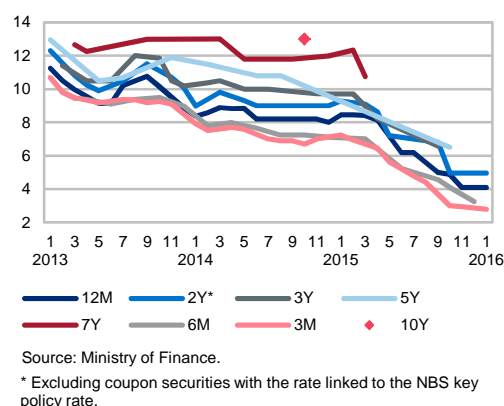


Chart IV.1.6 Interest rates on new dinar loans and new corporate and household deposits*
(weighted average values, p.a., in %)

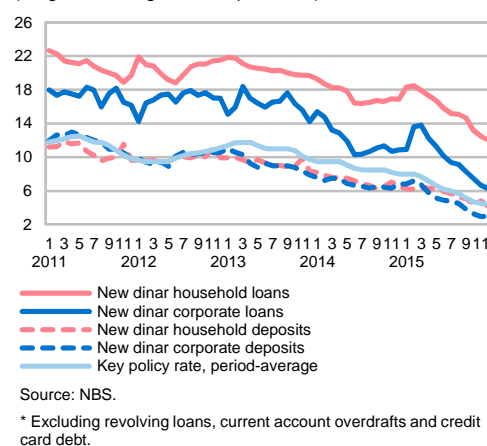
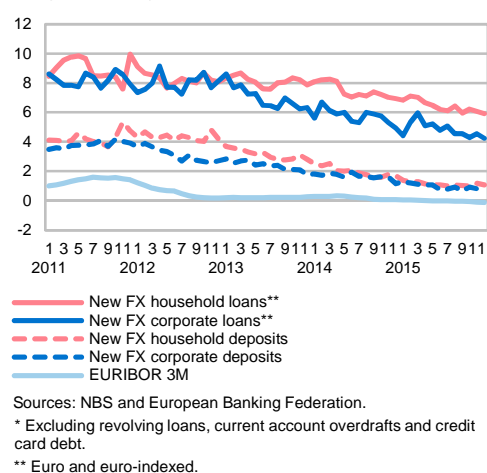


Chart IV.1.7 Interest rates on FX loans and corporate and household deposits*
(weighted average values, p.a., in %)



Text box 3: Fall in loan interest rates

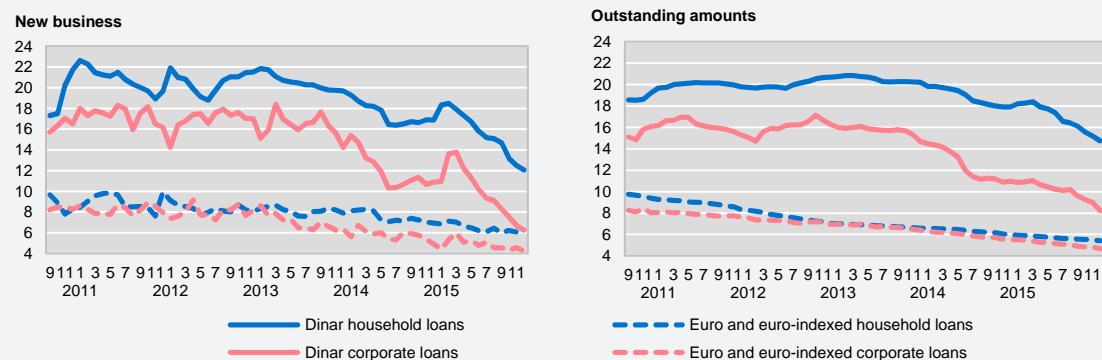
Interest rates on dinar and euro-indexed loans to the private sector are at their historic low since the new methodology for interest rate statistics was first applied. Corporate and household borrowing costs have been declining for three straight years, primarily on the back of the NBS's monetary policy easing, as well as low interest rates in the international money market and, as of recently, higher competitiveness among banks in the credit market. Dinar rates started to decline in September 2013, not long after the NBS launched a cycle of key policy rate cuts in May 2013. The key policy rate was reduced since then by 7.25 pp and the weighted average interest rate on new private sector dinar loans by 10.1 pp, down to 8.8% at end-2015. Rates on euro and euro-indexed loans were also decreased in the same period, though to a lesser extent (by 2.8 pp to 4.4%) relative to dinar loans, which can be associated with a milder decrease in EURIBOR.

Owing to the successful implementation of fiscal consolidation and Serbia's improved macroeconomic performances, there was sufficient room to step up monetary policy easing in 2015 (by 3.5 pp), which is why **dinar interest rates on new loans recorded the sharpest plunge in the very same year** (by 4.8 pp to 12.1% for households and 4.7 pp to 6.2% for corporates). Interest rates on euro and euro-indexed loans have also been on a decline for quite some time, primarily driven by a drop in interest rates in the international money market, but also because of a decline in the country risk premium. At the end of 2015, the average price of new euro and euro-indexed loans was 4.2% for corporates and 5.9% for households.

The fall in interest rates in the domestic and international interbank loan markets **was reflected on lower costs of funding outstanding corporate and household loans**. At the end of 2015, relative to September 2013, interest rates on outstanding dinar loans contracted by 7.6 pp to 8.2% for corporates and by 5.5 pp to 14.7% for households. During the same period, rates on euro and euro-indexed loans declined by 2.0 pp to 4.7% for corporates and by 1.3 pp to 5.4% for households. The drop in the costs of funding has helped the corporate sector reduce operating costs and improve business results, and facilitates the financing of new investment projects. As for households, lower rates allow for the increase in disposable income and alleviate short-term negative effects of wages and pensions that have been scaled down due to fiscal consolidation.

Chart O.3.1 **Movements in interest rates on household and corporate loans – new business and outstanding amounts**

(weighted average values, p.a., in %)



Source: NBS.

Unlike households, who for quite some time have been borrowing mainly in dinars (in 2015, more than two-thirds of new loans to the household sector was in dinars), the corporate sector's share of loans in dinars is much lower (around 17%). On its part, the NBS has secured preconditions for a rise in dinarisation – a low and stable inflation and relative stability of the foreign exchange rate, while at the same time encouraging banks through its policy of required reserves to use dinar and longer-term sources of funding. At the same time, owing to the development of the dinar government securities market, the yield curve has been extended to include sufficiently long maturities (seven and ten years) which may be used as benchmarks when defining interest rates on longer-maturity loans. With economic activity continuing to bounce back, we expect businesses to rely more on dinar loans and citizens to resort more often to longer-term dinar loans.

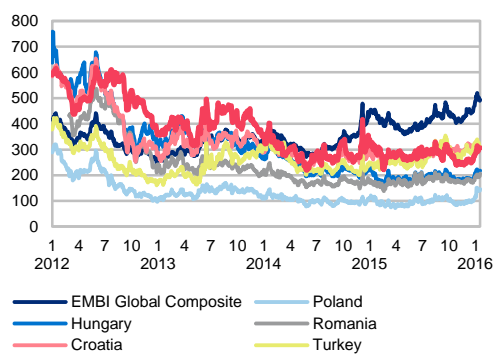
Risk premium

Following a rise in Q3, caused by turbulences in the international financial market, Serbia’s risk premium measured by EMBI declined in October and remained relatively stable until the year-end, at around 250 bp. At end-2015 it measured 254 bp, down by 56 bp from end-Q3. Other countries in the region also experienced a fall in the risk premium, though to a lesser extent. Owing to a sharper fall, Serbia’s risk premium trended below those of Croatia and Turkey throughout Q4. Serbia’s regional peers which experienced EMBI decline in Q4 were Turkey (55 bp), Hungary (40 bp), Romania (27 bp), Poland (14 bp) and Croatia (5 bp). Though the value of EMBI Global remained above 400 bp throughout the quarter, it fell by 28 bp q-o-q.

The fall in Serbia’s risk premium in Q4 may be largely ascribed to domestic factors, primarily a considerable narrowing of internal and external imbalances, efforts to bring public debt within sustainable boundaries, improvement in the country’s macroeconomic prospects, stronger potential for economic growth, as well as the IMF’s positive assessment of Serbia’s performance under the precautionary stand-by arrangement. The same factors led to the improvement of Serbia’s credit rating outlook by Fitch (in December 2015) and Standard & Poor’s (in January 2016).

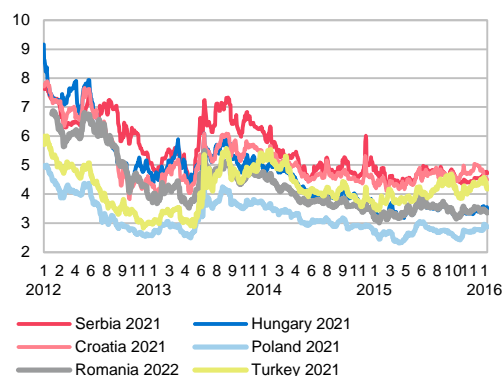
Risk premiums of Serbia and other regional peers were also largely influenced by the easing of global turbulences initially triggered by the August upheaval of Chinese markets and the news of potential slowing of China’s and consequently, global growth. In October, as the Chinese central bank relaxed its monetary policy stance and the FED postponed its interest rate hike, risk premiums of emerging countries were on a decline. In the ensuing two months external risks swelled, fuelled chiefly by uncertain reactions of market participants to the effects of expected increase in the FED’s rate on commodity and financial markets, and particularly on capital flows towards emerging economies, Serbia included. In addition, late December and early 2016 saw heightened uncertainties in the international financial and commodity markets over the increasingly certain deceleration of China’s economic growth and depreciation of its currency, fears that the global growth outlook might fall short of expectations, and a new decline in the prices of oil and other primary commodities. January thus saw an increase in risk premiums of emerging markets. EMBI Global went up from 48 bp to 494 bp, while EMBI for Serbia rose from 52 bp to 306 bp.

Chart IV.1.8 Risk premium indicator – EMBI by country (daily data, in bp)



Source: JP Morgan.

Chart IV.1.9 Yields on eurobonds of countries in the region (in %)



Source: Bloomberg.

Chart IV.1.10 Current account deficit and net capital inflow
(in EUR mln)

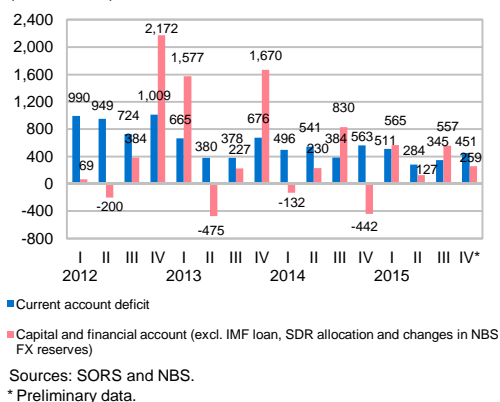


Chart IV.1.11 Structure of the financial account
(in EUR mln)

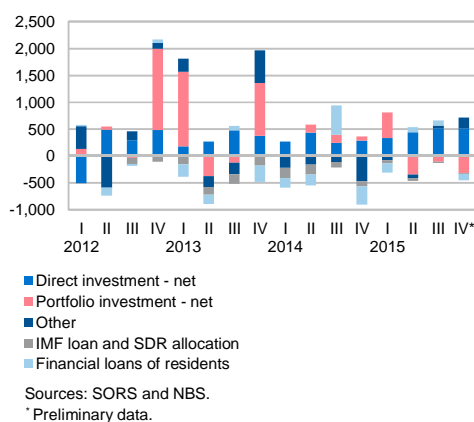
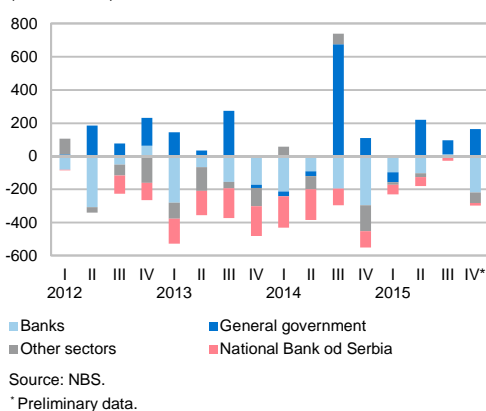


Chart IV.1.12 Financial loans of residents – change in net borrowing
(in EUR mln)



Foreign capital inflow

Although the current account deficit expanded relative to Q3, capital inflow from FDIs provided more than sufficient coverage. In addition, banks held lower balances in accounts abroad. An outflow was recorded in respect of portfolio investment and reduced credit liabilities of residents.

A stable **FDI** inflow which continued into Q4 reached, according to preliminary data, EUR 512.6 mln. Of this, EUR 255.5 mln was channelled into equity, EUR 107.1 mln in debt instruments and EUR 150.0 mln concerned reinvested earnings. At the same time, net foreign payments in regard to dividends and interests amounted to EUR 108.2 mln and EUR 24.6 mln, respectively.

According to preliminary data, FDI inflow in the last year came at EUR 1.8 bln, up by 45.6% y-o-y and in excess of NBS's expectations for 2015. This was the largest FDI inflow in the last four years and it fully covered the current account deficit. Investments were directed mainly into export-oriented sectors and dispersed across a variety of projects, which should warrant a sustainable economic growth. High level of foreign investments and inflow of around EUR 1.8 bln is expected in 2016 as well.

In respect of **portfolio investment**, Q4 saw a net capital outflow of EUR 313.9 mln, while interest payments to investors amounted to EUR 90.5 mln. Awaiting the FED's decision on interest rate rise, foreign investors reduced their exposure to emerging markets in 2015, and Serbia was no exception to this trend.

Resident liabilities arising from **financial loans** went down by EUR 132.0 mln in Q4. On this account, net government borrowing was up by EUR 164.0 mln, and the loans disbursed (EUR 369.8 mln) included EIB loans for Corridor 10 and IBRD loans for the Deposit Insurance Agency, improvement of cadastral administration and health sector. Despite a somewhat intensified servicing of foreign liabilities by banks around the end of the year (EUR 218,1 mln net in Q4), their cross-border repayment decelerated considerably in 2015 and total net outflow on this account (EUR 404.4 mln) was twice lower than the year before. As the NBS repaid EUR 14.7 mln of its liabilities due under the 2009 standby arrangement in Q4, the total repayment to the IMF in 2015 reached EUR 144.9 mln. Repayment of foreign loans by corporates also lost pace – total repayment on this account was EUR 63.2 mln in Q4 and EUR 101.9 mln in 2015, while trade loan debt rose by EUR 145.2 mln in Q4 and by EUR 219.1 mln since the start of the year.

Trends in the FX market and exchange rate

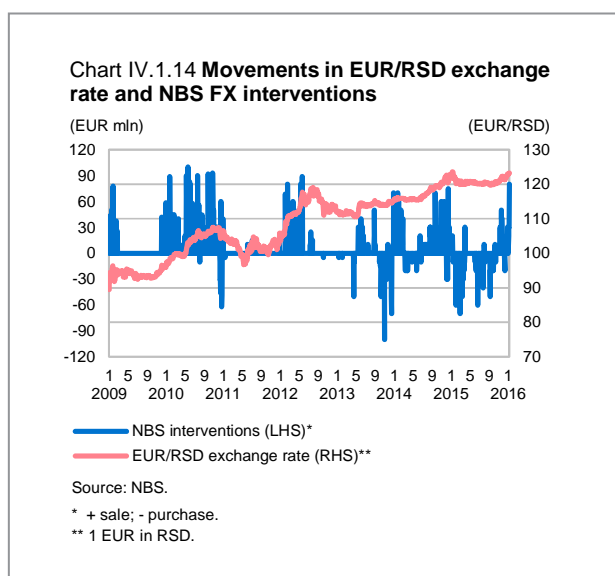
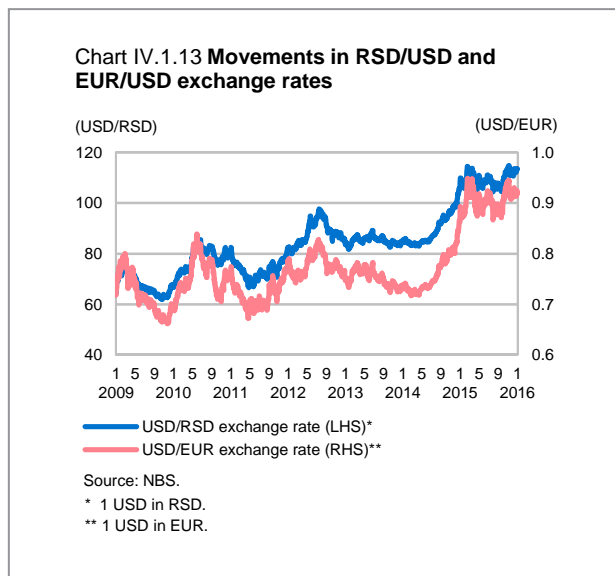
In 2015, the dinar was relatively stable, weakening by 0.5% vis-à-vis the euro at end of period. Appreciation pressures prevailed through the better part of the year, but gave in to depreciation pressures in Q4. During the last quarter, the dinar depreciated against the euro by 1.5% (end-of-period) and by 0.5% on average q-o-q.

Markets expectations for the Fed to increase its policy rate in December helped the dollar gain 2.9% against the euro. As a result, the dinar depreciated by 4.3% against the dollar in Q4 (end-of-period).

Pressures on the dinar in Q4 came also from foreign investors who acted as net FX buyers, mostly in the first half of December, on the eve of the Fed’s meeting. Prior to the tightening of the US monetary policy, these investors reduced their exposure towards emerging markets, Serbia included. Demand for foreign exchange in the domestic market was stronger, partly because of higher payments for energy imports and dividend payments to foreign owners. At the same time, banks and enterprises settled their foreign credit liabilities in somewhat higher amount than in Q3, which is usual for the turn of the year.

On the other hand, relatively high inflow of remittances in Q4 reflected on amounts of foreign cash purchases from exchange offices, which, along with the rise in FX-indexed bank assets⁸, improved the FX supply and cushioned the exchange rate from depreciation pressures. FDI inflow kept rising and significantly exceeded the amount of FDIs recorded in 2014. This speaks of favourable investors’ perceptions regarding the prospects for long-term investment in Serbia. The third successfully completed review of the arrangement with the IMF, further progress made on the EU accession path and improved credit ratings assigned by both Fitch and Standard and Poor’s confirm the results achieved in ensuring macroeconomic stability and improving business climate. These facts also give credence to positive expectations regarding further course of such trends. Consequently, risk premium, measured by EMBI, also declined in Q4.

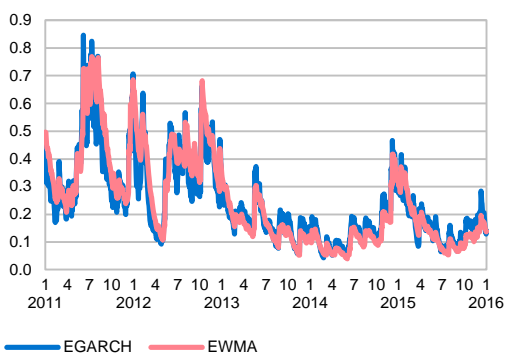
Trading volumes in the IFEM started recovering – they equalled EUR 32.8 mln daily on average in Q4, up by EUR 9.9 mln from Q3.⁹ The sharpest rise in trading



⁸ Banks increased FX supply in the IFEM in an effort to align their FX positions.

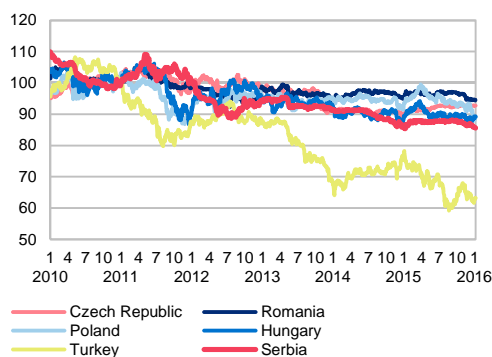
⁹ Excluding NBS.

Chart IV.1.15 Short-term volatility of the RSD/EUR exchange rate
(in %)



Source: NBS.

Chart IV.1.16 Movements in exchange rates of national currencies against the euro*
(daily data, December 31, 2010 = 100)



Sources: NBS and websites of central banks.

* Growth indicates appreciation.

volumes was recorded in December, when they averaged EUR 43.5 mln, which was also the second highest monthly value in 2015 (after February). Consistent with elevated trading volumes, volatility of the dinar against the euro also increased moderately, as measured by EWMA¹⁰ and EGARCH¹¹, but stayed nonetheless relatively low.

To ease excessive daily volatility of the exchange rate, the NBS intervened in the IFEM in Q4 both on the purchase side (total of EUR 110.0 mln) and on the sale side (total of EUR 320.0 mln), intervening the most in December. In the course of 2015, the NBS net bought EUR 520.0 mln in the IFEM.

The amount of FX swaps was somewhat lower than in Q3. At regular FX swap auctions organised by the NBS, it both sold and bought EUR 106.0 mln at two-week auctions, and EUR 26.0 mln at three-month auctions. The amount of interbank FX swaps equalled EUR 99.5 mln.

The early 2016 was marked by depreciations pressures caused by seasonally higher FX demand of energy importers, and partly by turbulences in the global financial market.

Although the withdrawal of foreign investors, who were expecting the Fed's policy tightening, did affect emerging countries in other regions more pronouncedly, its impact also reflected on Central and Eastern Europe, particularly in the first half of December. At the quarter level, the Romanian leu and Polish zloty lost 2.4% and 0.5% against the euro, respectively. The Hungarian forint stayed almost unchanged, while the Czech koruna jugged up by 0.6%. It was only the Turkish lira that recorded stronger movements – recovering briefly and gaining 7.7% in Q4 on the back of subdued political uncertainties.

Stock exchange trends

At end-December, BELEX15 (most liquid shares) equalled 644.1 points and BELEXline (general index of shares) 1,380.4 points, rising by 2.5% and 4.7%, respectively from late September. However, BELEX15 recovery in Q4 did not suffice to offset the fall recorded in previous quarters, so in the year as a whole, it lost 3.4%, unlike BELEXline, which rose by 2.7%.

¹⁰ EWMA – Exponentially Weighted Moving Average.

¹¹ EGARCH – Exponential General Autoregressive Conditional Heteroskedasticity.

Despite rising mildly relative to Q3 (by RSD 0.3 bln), trading in shares was rather low. Total trading in Q4 equalled RSD 4.1 bln, with highest trading volumes (RSD 2.6 bln) recorded in November, reflecting mainly trading in the open market.

Also, trading in bonds increased, by RSD 1.5 bln from Q3 to RSD 2.6 bln in Q4, helped by the decision to include long-term government securities in the BSE listing as of November. Trading in these securities amounted to RSD 1.6 bln in Q4. Trading in the remaining series of frozen FX savings bonds (A2016-series) was somewhat lower than in Q3 and came at RSD 1.0 bln. December also saw trading in municipal bonds.

Long-term government securities were traded under the first interbank repo transaction on the Serbian financial market, concluded in line with the standard Master Repo Agreement. The NBS also took part in its preparation. This marks a further step in the development of domestic financial market as repo transactions have so far been conducted only between the NBS and banks in open market operations. Given that the underlying security in the said repo transaction is a long-term dinar government bond, the development of these transactions could also boost the liquidity of the secondary market of government securities.

The BSE market capitalisation equalled RSD 683.4 bln in late December, contracting by RSD 31.5 bln from end-September. Of this, MTP¹² capitalisation fell by RSD 38.2 bln, while regulated market capitalisation rose by RSD 6.6 bln, owing to higher capitalisation of the open market. The share of market capitalisation in estimated GDP was down by 1.0 pp to 17.1% at end-Q3.

Most indices in regional stock exchanges recovered in Q4, at a pace similar or slower compared to the Belgrade Stock Exchange. A higher rise was recorded only in Budapest (14.5%) and Skopje (7.6%). On the other hand, the Banja Luka index was the only to continue downwards (6.4%).

2. Money and loans

The money supply increased in Q4, particularly its dinar component. An impulse to this increase came from a moderate recovery in lending activity. Namely, lending rose in 2015 despite the maturing of subsidized loans approved in the prior year.

Chart IV.1.17 BELEX15 and Belgrade Stock Exchange turnover

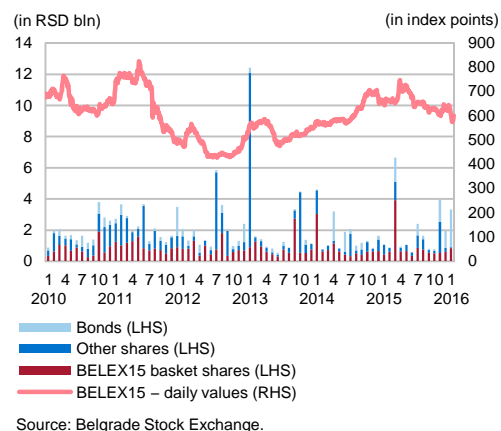
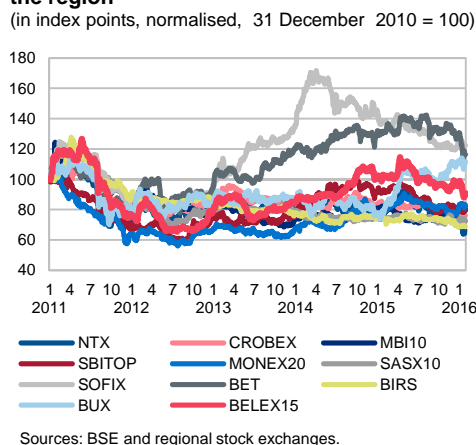


Chart IV.1.18 Stock exchange indices across the region



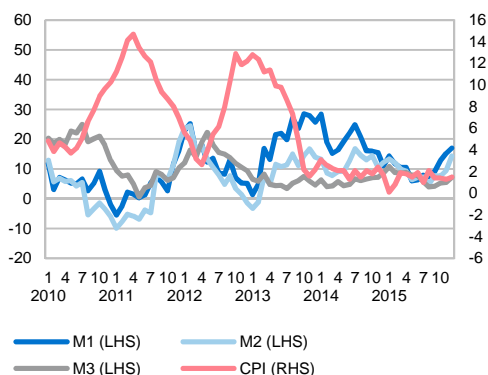
¹² MTP is the multilateral trading platform, set up by the Belgrade Stock Exchange and incorporating currently listed shares of companies not eligible for regulated market listing.

Table IV.2.1 Monetary aggregates
(real y-o-y rates, in %)

	2015				Share in M3 Dec. 2015 (%)
	March	June	Sep.	Dec.	
M3	6.5	5.8	2.7	5.6	100.0
FX deposits	5.9	6.1	10	2.1	64.9
M2	7.9	5.2	6.2	12.7	35.1
Time and savings dinar deposits	6.7	7.5	3.0	6.4	9.9
M1	8.4	4.3	7.6	15.4	25.2
Demand deposit	11.7	5.4	10.6	19.6	18.2
Currency in circulation	1.1	1.7	0.4	5.6	7.0

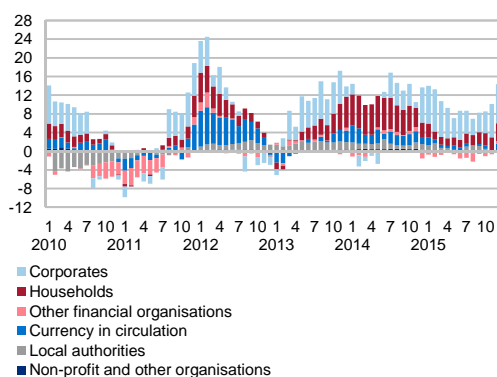
Source: NBS.

Chart IV.2.1 Monetary aggregates and CPI
(y-o-y rates, in %)



Sources: SORS and NBS.

Chart IV.2.2 Contribution to y-o-y growth in M2, by sector
(in pp)



Source: NBS.

Monetary aggregates

In Q4, dinar reserve money gained 9.6% in nominal and 10.1% in real terms. As banks temporarily held much higher amounts in accounts with the NBS at the close of the year than mandatory under FX reserve requirement, total reserve money was higher by 5.8% in nominal and 6.3% in real terms in Q4.

During Q4, banks' investment in repos declined by RSD 29.4 bln, which, together with FX payment transactions with Kosovo and Metohija (RSD 12.1 bln), made the largest contribution to dinar reserve money growth. Seasonal government spending of dinar deposits from its accounts with the NBS (RSD 8.9 bln in Q4) contributed to banks' liquidity position. A part of this liquidity was mopped up through NBS interventions in the IFEM (RSD 19.8 bln).

In terms of the composition of dinar reserve money, overnight bank deposits with the NBS increased the most (by RSD 24.0 bln). Currency in circulation was RSD 14.1 bln higher, and bank giro account balances gained RSD 11.0 bln. Dinar allocations of required reserves shrank by RSD 13.1 bln due to eased reserve requirement regulations. Balances on accounts of local governments and other sectors declined by RSD 1.4 bln.

The money supply increased further in Q4, at a slightly faster pace than in the preceding quarters. As usual for this season, all deposit categories went up, particularly dinar deposits. As a result, M1 and M2 increased in real terms by 11.8% and 11.7%, respectively, and M3 by 6.1%. Money supply growth accelerated in y-o-y terms, too – M1, M2 and M3 were 15.4%, 12.7% and 5.6% higher in real terms, respectively, in December relative to the same period last year.

A moderate recovery in lending provided an impulse to M3 creation in Q4 as well. Higher bank investment in government securities and government spending of deposits from its accounts with the NBS worked in the same direction.

A breakdown by M3 component shows that demand deposits increased the most in Q4 (RSD 36.6 bln). For the largest part, this rise was generated in company accounts, mainly in the manufacturing, trade, transport, real estate and construction sectors. Balances in household current accounts and OFO accounts also went up. Longer-term dinar deposits gained RSD 19.5 bln, due to higher balances in corporate and, to a smaller extent, household accounts.

The rise in dinar household savings continued into Q4, sustained by an extended period of low and stable inflation, relatively stable exchange rate, higher interest rates and preferential tax treatment of dinar relative to FX savings. At end-2015, dinar household savings reached a new high of RSD 45.4 bln, and continued rising in January 2016. Relative to September, they rose by RSD 3.3 bln, with households opting most for demand and one- to two-year time savings deposits. At the same time, household FX savings gained EUR 29.1 mln and reached EUR 8.3 bln at end-2015. They increased by a modest EUR 85.9 mln in 2015, as expected in the conditions of consistent implementation of fiscal consolidation.

In addition to household FX savings, corporate FX deposits also increased. As a result, total FX deposits rose by RSD 130.4 mln in Q4.

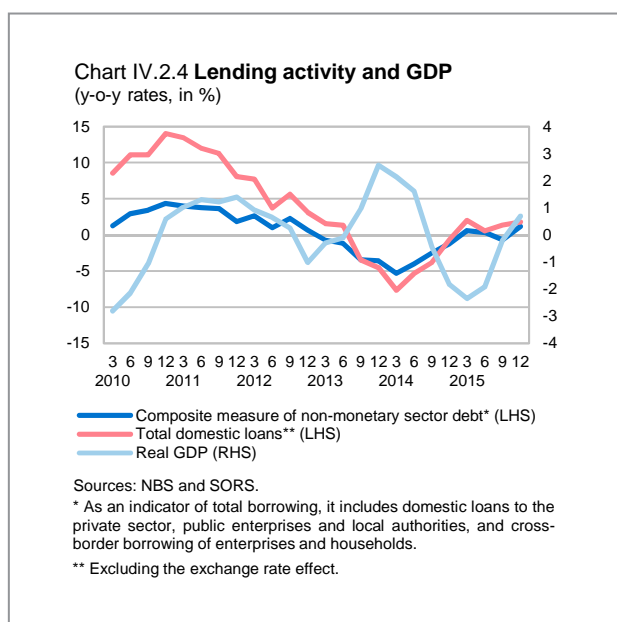
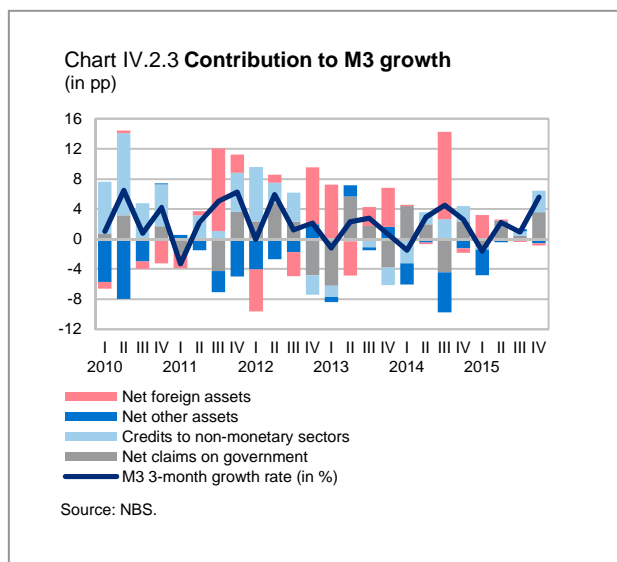
Loans

A moderate recovery in lending continued into Q4. This was the result of past monetary easing and the consequent fall in interest rates on dinar loans, as well as of low international money market rates. A part of the lending potential was also released through a new round of cuts in the reserve requirement ratios. In Q4, domestic loans gained 1.7%, excluding the exchange rate effect,¹³ with growth recorded in both corporate and household sectors.

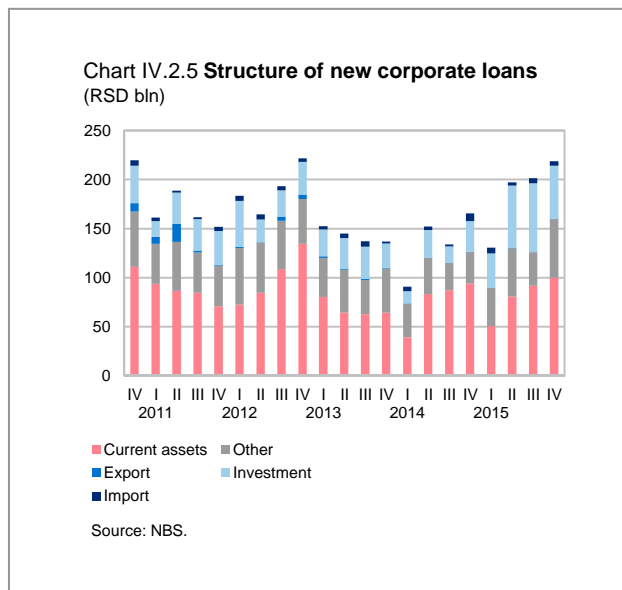
Although around RSD 110 bln or 80% of subsidised loans approved in the prior year matured for payment in 2015, total domestic loans, excluding the exchange rate effect, increased by 1.8% in 2015. Of this, corporate loans gained 1.2% and household loans 3.1%. At the same time, the share of domestic loans in estimated GDP rose by 0.5 pp in 2015 to 48.5% in December.

We expect the recovery in lending to continue in 2016 as a result of past monetary easing, persistently low euro area interest rates and anticipated acceleration of economic activity at home.

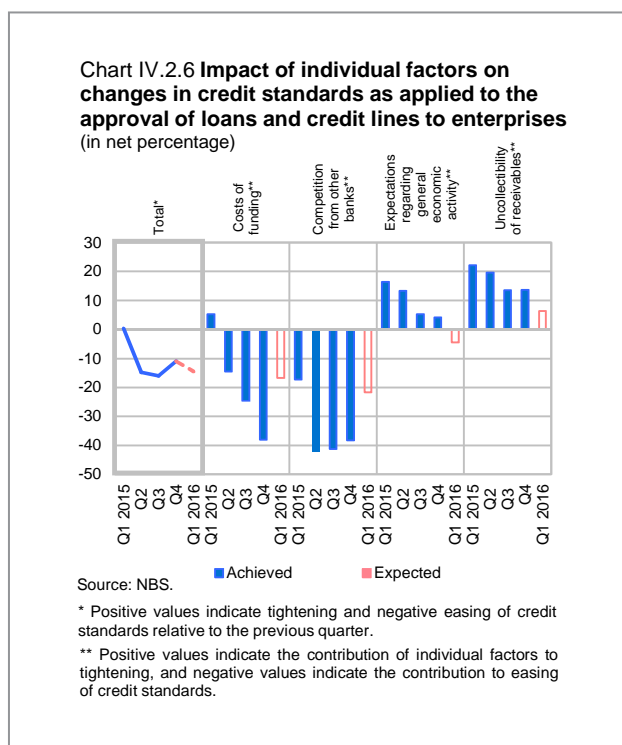
Although the bulk of subsidised loans matured during H2, the rise in corporate lending continued in Q4. Excluding the exchange rate effect, corporate loans went up by 2.4%, or RSD 26.4 bln, as a result of higher lending to companies (RSD 33.7 bln), while claims on public



¹³ Calculated at the dinar exchange rate against the euro, Swiss franc and US dollar as at 30 September 2014 (the so-called programme exchange rate used for the purpose of monitoring the IMF arrangement), according to the currency composition of loan receivables.



enterprises contracted by RSD 7.3 bln. The majority of these loans were approved to enterprises from the trade, energy and agriculture sectors. New corporate loans increased from Q3 and were dominated by loans for current assets and investment loans. As investment was increasingly financed from bank sources of funding in 2015, new investment loans rose substantially (by 150% y-o-y, to RSD 222.8 bln), which resulted in new corporate loans being 38% higher than in 2014. Positive trends were also confirmed by the fact that, even excluding loans refinanced under more favourable terms (around 25%), new corporate loans in 2015 were 4% higher than total new loans in 2014 when the subsidised lending scheme was in place. The rise in investment loans also contributed to the lengthening of the maturity of the loan portfolio, with the share of loans maturing in over two years up by 6.8 pp from 2014 to 64.3%.



According to the results of the January bank lending survey¹⁴, the trend of relaxation of standards continued into Q4. Banks reported similar expectations for Q1 2016. According to banks, standards were relaxed for both dinar and FX loans to small, medium and large enterprises. This was mostly due to increased competition among banks and cheaper sources of funding, while risks relating to the collection of receivables and growth prospects remained. By contrast to Q4, banks expect that the relaxation of standards in the period ahead will be driven by economic activity acceleration. Banks assessed that the terms of borrowing by corporates were more favourable in terms of shrinking margins, lower associated costs, longer terms of repayment and maximum loan amount. Demand by all types of enterprises continued rising, motivated by the need to finance current assets and restructure existing debts. The same factors are expected to drive demand in the period ahead.

The rise in household loans was sustained in Q4. Excluding the exchange rate effect, they rose by 0.8% or RSD 5.2 bln. By contrast to corporates, households mostly borrowed in dinars, and the volume of new loans was slightly higher than in Q3. As before, households opted most for cash loans, which made up around 60% of new loans and their maturity was extended. Housing loans were somewhat lower and other loans somewhat higher than in Q3, accounting for around 13% and 23% of new loans, respectively. Households resorted somewhat less to costlier loan categories, credit cards and the use of current account overdrafts.

¹⁴ The NBS has conducted the survey since early 2014. Participation is voluntary and the response rate almost 100%

The results of the January bank lending survey confirmed expectations of sustained relaxation of standards and rising household demand in Q4. Standards were relaxed for all household loan categories, for the same reasons as in the case of corporate loans, and are expected to be relaxed further in Q1 2016. Interest rate margins and associated costs were lowered and requirements with regard to collateral further eased, while other terms were not changed. Households opted most for refinancing, cash and consumer loans. Banks expect demand to continue rising, driven by the need to refinance existing obligations, while low household income and the still high unemployment will continue to curb their new borrowing.

The share of dinar loans in total corporate and household loans declined by 2.6 pp from end-2014 to 28.6% at end-December. The degree of dinarisation of corporate lending fell to 19.4% at end-Q4 due to the maturing of subsidised dinar loans and an increase in new FX borrowing. By contrast to the corporate sector, households mostly borrowed in dinars. As a result, the dinarisation of household lending continued up and reached 42.8% in December.

In Q4, the share of NPLs in total loans, on a gross basis, climbed 0.3 pp to 22.3% in November. The share of NPLs continued to decrease in the corporate and household sectors, which make up most of the loan portfolio, but increased in the sectors of finance and insurance, foreign persons and other clients. The share of corporate NPLs shrank by 0.4 pp to 23.7% and the share of household NPLs by 0.2 pp to 10.9%¹⁵. This was due to the recovery in lending, but also to collection, write-off and restructuring of a part of NPLs.

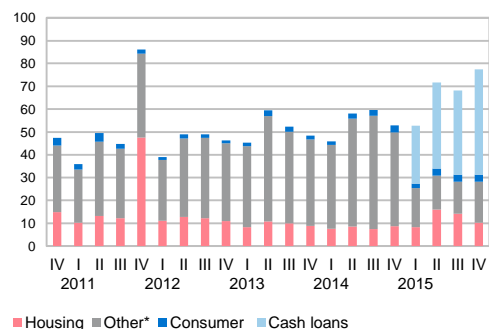
Despite the high share of NPLs in total loans, the capital adequacy ratio of around 20% indicates that the domestic banking sector is stable. In November, total allowances for loan impairment came at 61.4% of NPLs, while loan loss provisions,¹⁶ at 112.9% in November, continued to fully cover the amount of gross NPLs.

The results of special diagnostic studies (SDS) of banks' balance sheets as at 31 March 2015 have confirmed that Serbia's banking sector is well capitalised. The SDS are an important part of the IMF arrangement relating to the

¹⁵ With entrepreneurs and private households included, the share fell by 0.2 pp to 11.8%.

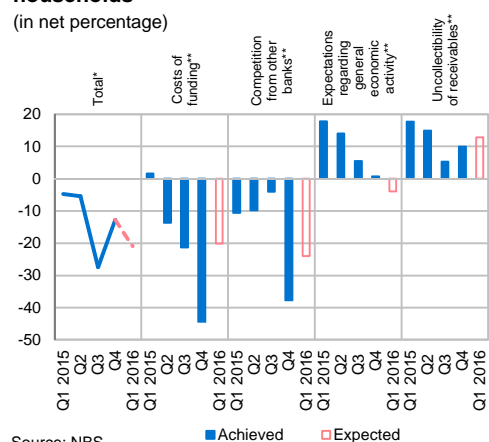
¹⁶ Loan loss provisions are not an accounting category, meaning they are not recorded in the income statement but only serve for the calculation of bank capital. They are calculated on a group basis by asset classes that provisioning levels are defined for (0%, 2%, 15%, 30% and 100% for receivables classified in A, B, C, D and E categories, respectively).

Chart IV.2.7 Structure of new household loans (RSD bln)



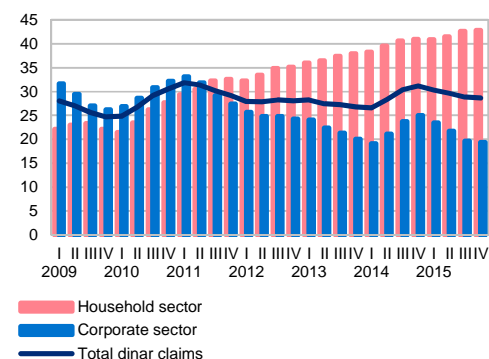
Source: NBS.
* Until December 2014, the 'Other loans' category included cash loans and other loans together.

Chart IV.2.8 Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to households (in net percentage)



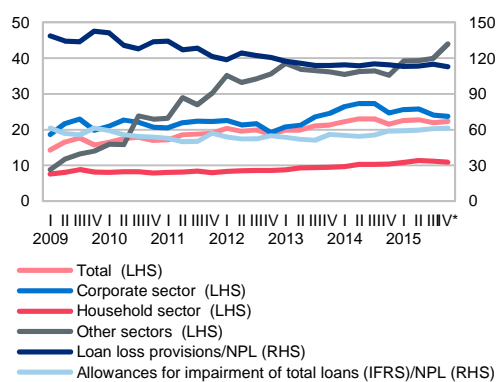
Source: NBS.
* Positive values indicate tightening and negative easing of credit standards relative to the previous quarter.
** Positive values indicate the contribution of individual factors to tightening, and negative values indicate the contribution to easing of credit standards.

Chart IV.2.9 Share of dinar in total bank receivables from corporate and household sectors (in %)



Source: NBS.

Chart IV.2.10 NPL share in total loans, gross principle
(in %)



Source: NBS.
* November 2015.

financial sector segment. Despite conservative assumptions underlying the SDS, all banks participating in the SDS (14 banks accounting for 88% of banking sector assets) had a capital adequacy ratio above the regulatory minimum of 12%.¹⁷ The overall net impact of SDS adjustment on the capital of in-scope banks was a decrease of the capital adequacy ratio by 1.76 pp (from 20.21% to 18.45% after the SDS), which is still well above the domestic and foreign regulatory minimums.

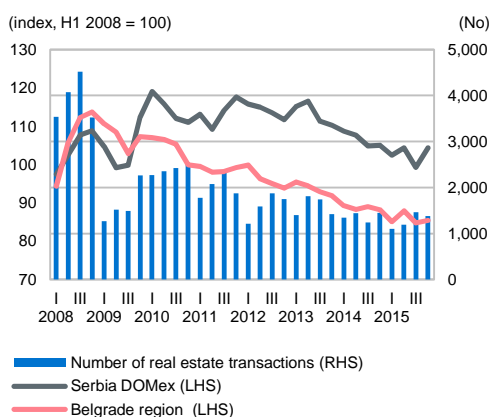
3. Real estate market

Real estate supply increased further in Q4. This, coupled with lower costs of funding, is expected to have a positive effect on housing loan demand. Still, turnover edged down relative to Q3 as real estate prices saw a mild upturn.

After declining in Q3, Serbia's average real estate prices, as measured by the *DOMex*¹⁸, gained 5.1% in Q4. Prices increased across all regions, but the rise was particularly pronounced in Vojvodina (12.5%). The q-o-q increase in the real estate price slowed its y-o-y decline to 0.6% in Q4. At annual level, real estate prices in Serbia declined in 2015 for the third year in a row and were 3.7% lower on average than in 2014.

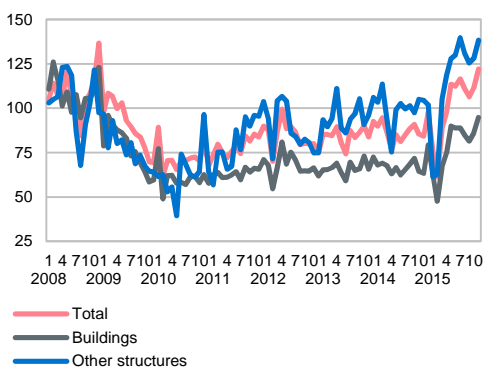
The average real estate price in Serbia was EUR 865.3 per square meter in Q4, which is slightly above the 2015 average (EUR 850.3 per square meter). Regional differences in real estate prices continued to shrink in Q4, with the ratio of the average price in the costliest region (Belgrade) relative to the rest of Serbia contracting to 1.71. The slight increase in prices reflected on turnover¹⁹ which fell by 5.5% in Q4. Sales of real estate increased in the Belgrade region, while declining in the rest of Serbia.

Chart IV.3.1 DOMex and real estate transactions



Source: National Mortgage Insurance Corporation.

Chart IV.3.2 Indices of the number of issued construction permits
(s-a data, H1 2008 = 100)



Sources: SORS and NBS calculation.

Interest rates on housing loans, both euro-indexed and in dinars, fell further in Q4, which, according to banks' expectations as stated in the most recent bank lending survey, could encourage a mild rise in household demand for this type of loans in Q1 2016. The supply of flats also went up, as the number of issued construction permits rose by 61.0% y-o-y in October and November and 20.3% y-o-y in the first eleven months of 2015. This might signal

¹⁷ Report on special diagnostic studies of banks is available at: http://www.nbs.rs/export/sites/default/internet/latinica/55/55_0/2015_aqr_PDI.pdf

¹⁸ The *DOMex* is published by the National Mortgage Insurance Corporation and relates only to real estate purchased by insured loans. Though it does not monitor purchase/sale transactions financed by own funds or uninsured loans, the *DOMex* is judged to mirror trends in the real estate market, considering high unemployment levels, declining wages and muted lending activity.

¹⁹ The number of real estate transactions and flat prices per square meter also relate only to real estate purchased by insured loans.

recovery in the construction industry in the period ahead, which will be aided by further simplification of the permitting procedure and introduction of an electronic construction permit in early 2016.

4. Aggregate demand

Q4 saw a further lowering of operating expenses and continued implementation of infrastructural projects. This, together with an improved business and investment climate, provided an impulse to growth in fixed investment which, similarly as in Q3, was the key driver of GDP growth. To a smaller extent, a positive contribution also came from final consumption of households and the government, while the contribution of net exports was slightly negative.

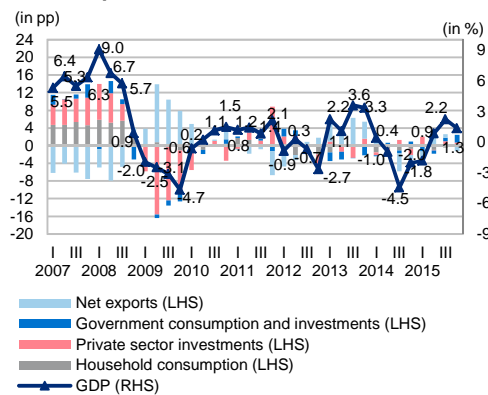
According to our estimate, the 0.8% annual GDP growth resulted primarily from a strong upswing in private, and to a lesser extent, government investment, which saw notably higher growth dynamics in H2. The contribution of net exports was neutral, as the rise in export demand, triggered by euro area recovery, was offset by swelling imports of equipment. As anticipated, final household and government consumption contributed negatively to GDP growth in the context of consistent implementation of fiscal consolidation measures. This effect was, however, more moderate than expected as disposable income went up due to lower costs of loan repayment, rising foreign remittances and falling oil prices.

Domestic demand

The rise in **household consumption** recorded in the prior two quarters is expected to continue in Q4, as signalled by most indicators. Retail trade turnover gained 1.6% s-a and imports of consumer goods were 2.1% higher, s-a, than in Q3. Also, the majority of other branch indicators (turnover in catering and passenger transport, postal and telecommunications activities) recorded growth. **Y-o-y**, household consumption continued down (0.2%), but at a much slower pace than in the prior three quarters.

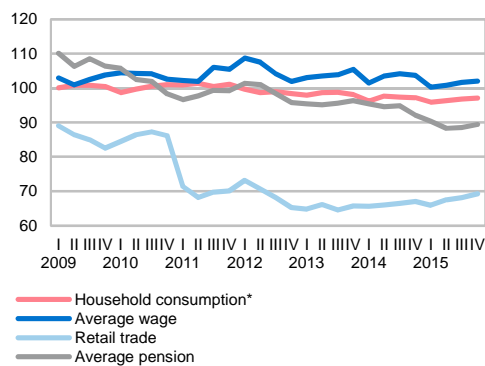
Movements in the main sources of consumption also signal a rise in household consumption. Real net wage bill inched up slightly, while notable growth in social insurance transfers (6.8% s-a) can be ascribed to payment of pension arrears to military personnel. There was a slight increase in household consumer loans and inflow of remittances from abroad which continued up in y-o-y terms in Q4.

Chart IV.4.1 Contributions to y-o-y GDP growth rate – expenditure side



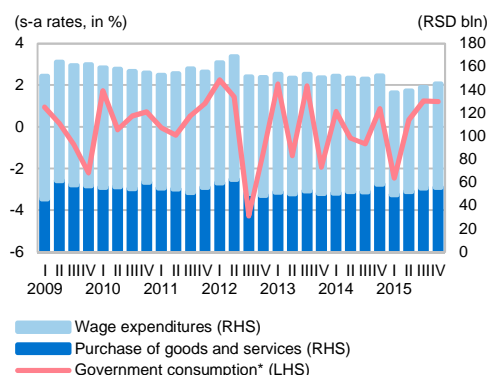
Note: NBS estimate for Q4 2015.
Sources: SORS and NBS calculation.

Chart IV.4.2 Household consumption (s-a data, H1 2008 = 100)



Sources: SORS and NBS calculation.
* NBS estimate for Q4 2015.

Chart IV.4.3 Government consumption (in real terms)



Sources: SORS, Ministry of Finance and NBS calculation.
* NBS estimate for Q4 2015.

Table IV.4.1 Investment indicators

	2014		2015		
	IV	I	II	III	IV
Real indicators (seasonally-adjusted, quarterly growth, in %)					
Industrial inventories	-0.6	4.5	-0.5	0.8	-4.2
Industrial production of capital goods	-0.8	11.4	-4.9	-10.1	3.6
Exports of equipment*	-3.4	33.1	-6.1	5.7	1.7
Imports of equipment*	3.8	4.7	1.9	-0.7	-2.5
Inventories of capital goods	5.8	3.7	2.4	-5.1	2.0
Industrial production of intermediate goods	-2.1	6.4	1.6	-0.8	2.5
Exports of intermediate goods*	1.7	3.0	4.6	1.6	4.3
Imports of intermediate goods*	0.9	7.0	1.8	0.8	3.5
Inventories of intermediate goods	-0.7	-0.2	2.1	-0.7	0.5
Industrial production of construction materials	1.1	-5.2	7.9	-1.6	8.5
Inventories of construction materials	-1.9	-2.2	-5.2	-6.0	2.1
Government investment**	-6.4	-8.3	50.3	3.3	13.4

Source: SORS and NBS calculation.

* Exports and imports are denominated in euros.

** Government investment spending is deflated by the industrial producer price index.

According to our estimate, **private investment** increased in Q4 (0.4% s-a), contributing 0.1 pp to GDP growth.²⁰ This is signalled by higher domestic production of capital goods (3.6% s-a) and construction material (8.5% s-a), as well as by a larger number of issued construction permits (7.2% s-a). Private investment growth continued in y-o-y terms as well (3.1%), providing a 0.5 pp positive contribution to GDP.

Changes in the main sources of investment funding confirm our expectations of investment growth in Q4. A more favourable investment climate encouraged an increase in net FDI inflows by 78.9% y-o-y in Q4 and by 45.6% at year level. Further, lower interest rates in the international and local financial markets and falling oil prices resulted in an improved financial position of corporates and greater reliance on own sources of funding, but also higher borrowing from banks.

Rising at an estimated 1.2% s-a, final **government consumption** gave a positive 0.2 pp contribution to GDP in Q4. The y-o-y rise in this component continued (0.8%), driven by increased expenditures for the purchase of goods and services. By contrast, wage expenditures contracted for the seventh consecutive quarter and their average decline for the year was 9.7%.

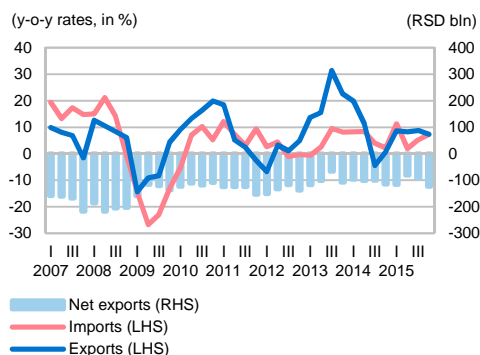
Government investment is also estimated to have recorded quarterly growth (13.4%, s-a), contributing 0.4 pp to GDP. This is signalled by real growth in consolidated government capital expenditure which accelerated in H2 due to construction and renovation of infrastructural facilities. Y-o-y, this demand component continued its relatively strong increase (50.3%).

Net external demand

As economic confidence in the euro area gradually improved, the indicator of external demand for Serbia's exports²¹ inched further up. This reflected positively on movements in real exports of goods and services which gained 1.8% s-a. As real imports of goods and services also increased (1.6% s-a), the contribution of net exports to GDP was slightly negative in Q4 (0.1 pp). Y-o-y, imports and exports of goods and services recorded the same growth in real terms, but the contribution of net

Chart IV.4.4 Exports and imports of goods and services

(in previous-year constant prices, ref. 2010)



Sources: SORS and NBS calculation.

Note: Q4 2015 is NBS estimate.

²⁰ See: Text box 4, p 35.²¹ The leading indicator of external demand for Serbian exports was constructed based on movements in the European Sentiment Indicator (ESI). It includes 20 of Serbia's most important foreign trade partners and their shares in Serbian exports are used as weights.

exports was negative (1.0 pp) because the share of imports in GDP was higher.

By contrast to Q3, commodity exports in euro terms gained 2.6% s-a in Q4, driven by a recovery in manufacturing industry exports. Exports of motor vehicles picked up by 3.8% s-a, which was rather in line with our expectations given their low level in Q3. Fiat’s exports in 2015 totalled at EUR 1.2 bln, or 13% down from 2014. Still, motor vehicles remained Serbia’s most important export product and Fiat its largest single exporter in 2015.

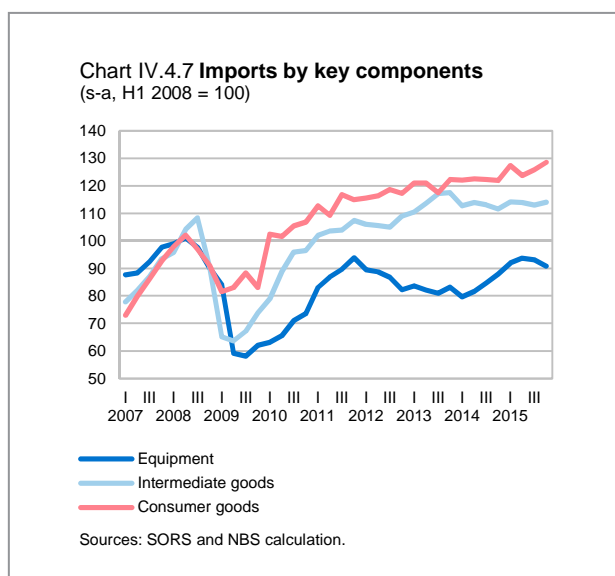
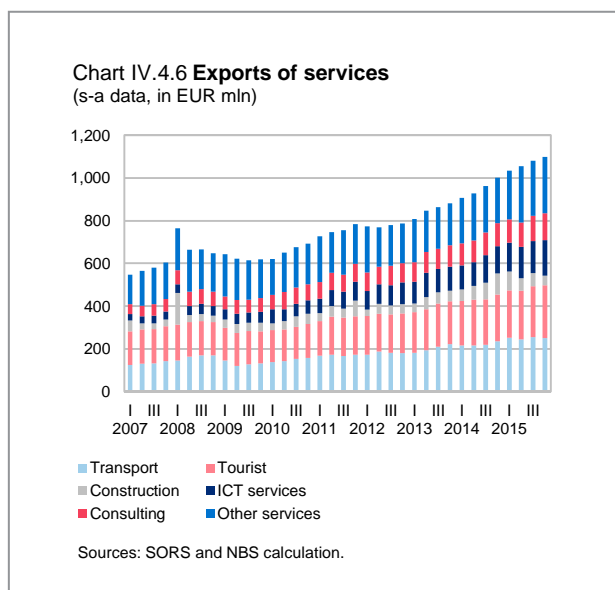
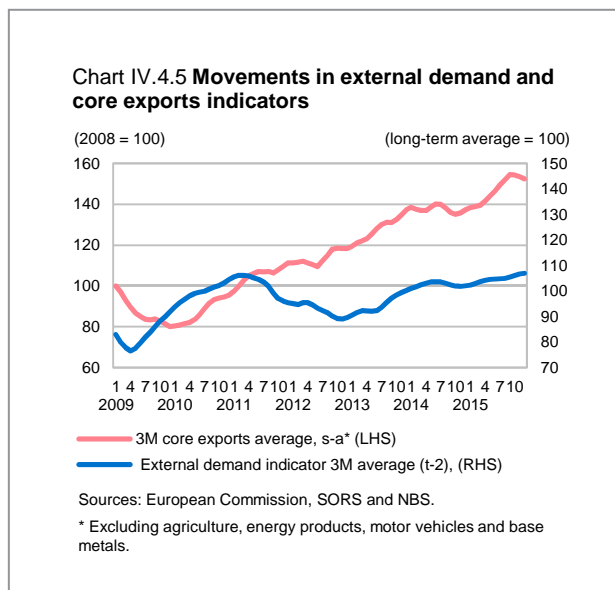
In addition to exports of motor vehicles, metal industry exports also rose in Q4, in particular exports of base metals (3.5% s-a) and metal products (4.8% s-a.). This is also confirmed by the fact that as many as four companies operating in these two branches of manufacturing were among 15 largest single exporters in 2015. The most significant among them is the Smederevo steel plant which exported goods worth EUR 319.0 mln in 2015 – an increase of 55% y-o-y.

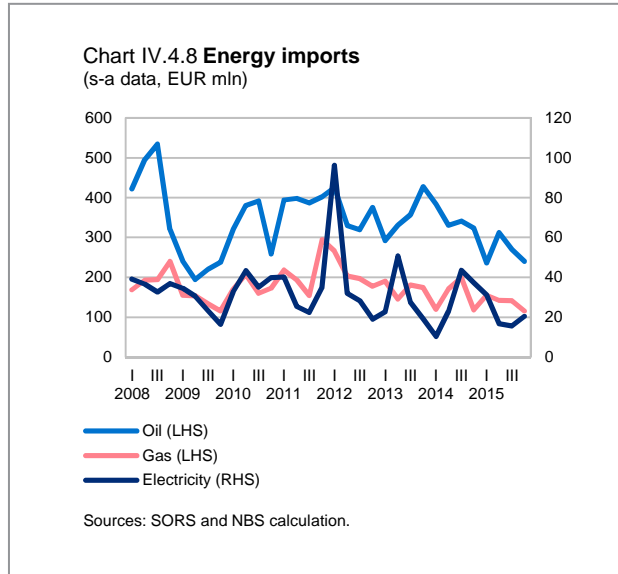
Exports of rubber and plastic products, machines, equipment and clothing also increased from a quarter earlier. By contrast, exports declined in the food industry on the back of a somewhat poorer agricultural season, as did exports of petroleum products on account of continued fall in global oil prices. Exports of electrical equipment, tobacco and chemical products also decreased.

Exports of agricultural products contracted by 13.9%, s-a, in Q4, mostly due to slower pace of wheat exports relative to Q3 (around 20%). With the arrival of the new harvest on the market, exports of corn went up, but as global demand for this commodity was muted due to high output, much lower amounts were exported than in Q4 2014 (around 70%). With exports of fruit and vegetables maintaining their relatively high levels from Q3, exports of these products were higher by around 50% in H2 relative to H1.

In addition to exports of goods, exports of services also increased further in Q4 (1.7% s-a). The strongest growth was recorded for exports of computer and information services (11.3% s-a), while the rate of growth in exports of consulting (6.2% s-a) and travel services (3.4% s-a) was somewhat lower. Exports of transport services were lower q-o-q (1.4% s-a), but continued to increase notably in y-o-y terms in Q4 (8.8%).

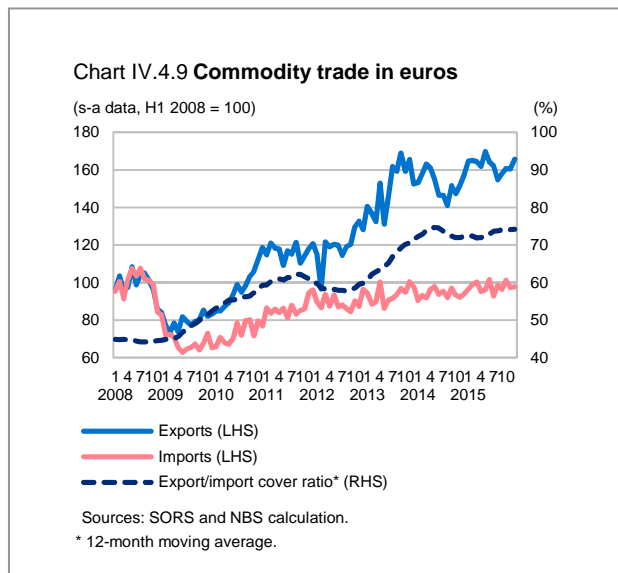
Commodity imports increased in euro terms by 3.0% s-a in Q4, driven by higher imports of intermediate goods (0.9% s-a) and consumer goods (2.1% s-a). Equipment





imports dropped slightly relative to earlier quarters (2.5% s-a). However, as Q4 also saw a substantial increase in imports of non-classified products, a part of which represents equipment, we may see an increase in equipment imports after reclassification.

Observed by economic destination of the EU, imports of intermediate goods and consumer durables increased. Energy imports declined further, due, as in previous quarters, to lower global oil prices. Imports of crude oil and petroleum products were lower by 11.1% s-a and imports of natural gas by 18.3% s-a. Electricity imports spiked in Q4 because of the overhaul in a number of hydroelectric plants in October. Similarly as in the prior period, imports of capital goods also decreased, on account of lower imports of motor vehicles and components for the automobile industry.



Indicators of Serbia's foreign trade position improved further in Q4. Commodity export/import cover ratio edged up by 0.1 pp relative to September to 74.2% in December, close to the peaks recorded in mid-2014. Also, commodity exports rose further to 65.7% above their pre-crisis level²² in December, while commodity imports were 2.3% below their pre-crisis level.

In Q4, external price competitiveness improved, due to the 0.9% real depreciation of the effective exchange rate in that period. By contrast, external cost competitiveness fell as unit labour costs in the manufacturing industry went up (1.8% s-a).

²² Level from H1 2008.

Text box 4: Investment as a driver of GDP growth in 2015

The global economic crisis revealed all the weaknesses of a consumption- and import-driven growth model. It was this kind of growth that, in an environment of reduced foreign capital inflows, made Serbia's external trade position unsustainable. Switching to a new model of growth based on investment and exports was therefore unavoidable. The new model allows for a reduction of external imbalances in two ways: in conditions of insufficiently high domestic accumulation, investment is financed also from FDI inflow, which contributes to the coverage of the current account deficit, while the activation of FDI bolsters the country's export-oriented economy.

The first major post-crisis wave of investment washed through the Serbian economy in 2011 and 2012. In those years, fixed investment increased by 4.6% and 13.2%, adding respectively 0.8 pp and 2.5 pp to GDP growth. Much of investment was channelled into export-oriented sectors and its activation contributed to a robust real export growth in 2013 (21.3%), resulting in a 4.8 pp contribution of net exports to GDP. However, as this robust growth was led by no more than a few branches of manufacturing (notably, automobile and oil industry), with the waning of the initial effects, total export growth slowed down too (5.7% in 2014). In comparison, the 2015 wave of investment in Serbia appears to be much more favourable both from the aspect of ensuring the potential for long-term growth and easing cyclical fluctuations in the economy. Data on FDI in 2015 show the prevalence of investors with smaller stakes, which creates a broader base for a more stable export growth in the years ahead. In addition, investment dispersion across different areas of manufacturing is greater, facilitating adjustment to potential fluctuations of economic cycles.

It was exactly owing to investment that the Serbian economy recorded 0.8% growth in 2015 despite fiscal consolidation. On the production side, the investment upturn is reflected primarily in the vibrant growth of the construction industry.

Table O.4.1 Investment indicators in 2015

(y-o-y growth rates, in %)

Construction sector (national accounts)*	10.4
Number of issued construction permits	23.2
Production of construction material	3.0
Value of works done (territory of Serbia)*	19.7
of which: - buildings*	4.6
- other (infrastructure)*	25.8
Gross fixed capital formation (national accounts)*	7.8
Imports of equipment	12.3
Production of machines and equipment	19.1
Repair and installation of machinery and equipment	6.6

Sources: SORS and NBS calculation.

*January–September.

Based on preliminary estimates of the Serbian Statistical Office, in 2015 the construction industry recorded growth for the first time in three years. Namely, it rose by around 10%, adding 0.4 pp to GDP growth as suggested by almost all of the key indicators. In the first three quarters of 2015, the value of construction works increased by 19.7% y-o-y. At the same time, the value of buildings in construction rose by 4.6% and the value of infrastructure construction works by as much as 25.8%. The number of workers on construction sites went up by 2.4% and effective hours of work by 3.3%. Positive trends were also recorded in the production of construction materials, whose physical volume expanded by 3.0% in 2015. Good prospects for the construction industry are further indicated by the number of issued construction permits that increased in the

first eleven months of 2015 by about 23.2% y-o-y, with a rise in the anticipated value of works of around 60% for apartment buildings and around 120.7% for infrastructure. Positive developments in investment in 2015 were registered not only for the construction industry, but also for investment in equipment. This is signalled by the strong growth in imports of equipment (12.3%) and domestic production of machinery and equipment (19.1%).

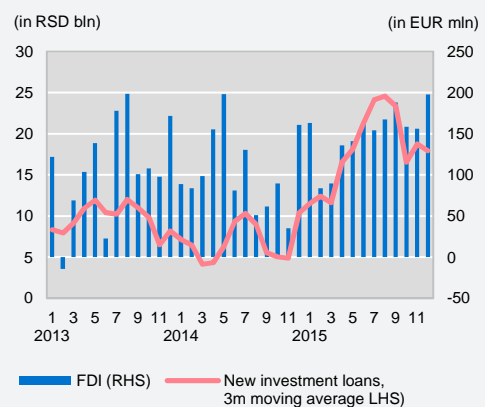
Investment was chiefly financed from FDI inflow, and in part by company profit and investment loans. According to the preliminary estimate, total net FDI inflow in 2015 exceeded EUR 1.8 bln, up by 45.6% from a year before. Also, the structure of FDI inflows by sector improved, as the proportion channelled to export-oriented sectors (agriculture, manufacturing, transport and food and accommodation services) in total net FDIs increased from 35% in 2014 to 42% in the first three quarters of 2015. Also, there was an improvement in terms of the form of investment, as investment in equity capital and reinvestment of earnings went up and the volume of intercompany lending declined.

Speaking of company profit, it should be noted that though the corporate sector recorded negative net financial result in 2014, one segment recorded a positive result of RSD 16.6 bln, that is, after public enterprises and companies undergoing restructuring are excluded from the total. Financial position of corporates improved also thanks to lower interest rates in the international and domestic markets. Cheaper borrowing made the new wave of investment more reliant on bank loans. This is clearly indicated by a considerably higher volume of new investment loans which was 150% higher in 2015 than in 2014.

A key driver of investment growth were improvements in the business and investment ambience brought about by a set of reform laws enacted since mid-2014. Amendments and supplements to the Labour Law increased flexibility of the labour market, supporting investment activity. In addition, novel legal solutions for the construction sector facilitated and partially accelerated the process of construction and legalisation of facilities. The major innovation in the Law on Planning and Construction is electronic issuance of construction permits, which should cut the time and costs of obtaining a permit. Permit issuance and the construction sector in general are likely to receive a positive impetus from the new Law on Conversion of the Right of Use of Construction Land Into Ownership Right With a Fee, which makes it easier to investors to acquire ownership of construction land, as a precondition for obtaining a construction permit. Further tailwinds to investment ambience should come from the new Investment Law, which equalises the rights of domestic and foreign investors and increases efficiency of administration in the provision of investment related services.

A significant support to investments comes from macroeconomic stability, in whose achievement, at least when it comes to price and financial stability, the NBS plays an important role. This is one more area where considerable progress was made in 2015, as confirmed by three successfully completed reviews of the arrangement with the IMF, improved outlook for the country's credit rating, progress on the global competitiveness ranking, etc. Despite the challenges stemming from the international environment, low and stable inflation continued in 2015 which, together with a relatively stable exchange rate and preserved stability of the financial system contributed to a predictable investment and business environment. The NBS intends to stay on the same course in the period ahead, ensuring the conditions within its remit which are necessary for accelerated but sustainable economic growth.

Chart O.4.1 New investment loans and FDI



Sources: SORS and NBS calculation.

5. Economic activity

A rebound in industrial production and continuation of positive movements in construction pushed GDP up by 0.2% s-a in Q4, while a decline in agricultural production, estimated at around 8.0% at annual level, acted in the opposite direction. The relatively strong GDP growth continued y-o-y and equalled 1.3%, according to the preliminary estimate of the Serbian Statistical Office.

The projected 2015 GDP growth rate of 0.8% was kept unchanged relative to our previous forecast, while a slightly weaker than expected rise in industrial production was offset by a slightly lower than anticipated drop in the services sector.

Following a moderate decline in Q3, prompted by the anticipated contraction in industrial production²³, estimated GDP growth in Q4 measured 0.2% in s-a terms. As in H1, GDP growth in Q4 was again driven by positive movements in industry and construction. A positive contribution, though smaller, also came from several service sectors (trade, transport, accommodation and food, information and communications). By contrast, a negative contribution derived from agriculture, which registered an annual drop of around 8.0%, and from some of the government-related services (public administration, education, healthcare and social protection).

GDP growth in Q4 was also recorded in y-o-y terms and, according to the preliminary estimate of the Serbian Statistical Office, equalled 1.3%. A slower pace of growth relative to a quarter earlier (2.2% y-o-y) was mostly due to the slightly abated, though still robust growth of industry and construction. A positive push to GDP growth in Q4 also came from some of the service sectors, while major downward pressure originated from agriculture. Given the revised growth rates in the first three quarters²⁴ and a preliminary assessment for Q4, we estimate that GDP growth in 2015 was 0.8%, which corresponds to the level of growth projected in the November *Inflation Report*.

Following the expected decline in Q3, the volume of industrial production increased by 0.5% s-a in Q4. Higher volume of production was recorded in the mining sector (0.8% s-a), with coal exploitation going up, while crude

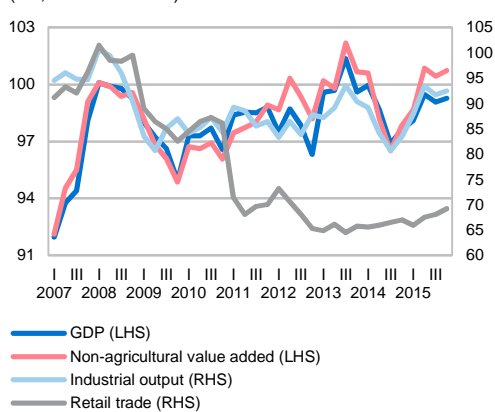
Table IV.5.1 Annual GDP growth and contributions

	2013		2014		2015*	
	%	pp	%	pp	%	pp
GDP	2.6	2.6	-1.8	-1.8	0.8	0.8
Agriculture	20.9	1.5	2.0	0.1	-8.0	-0.7
Industry	6.0	1.2	-7.4	-1.6	6.4	1.3
Manufacturing	5.7	0.8	-2.1	-0.3	4.0	0.6
Mining and energy	8.8	0.4	-27.0	-1.3	18.9	0.7
Construction	-3.9	-0.2	-1.5	-0.1	10.0	0.4
Services	0.3	0.1	-0.2	-0.1	-0.6	-0.2
Net taxes	-1.3	-0.2	-0.8	-0.1	0.2	0.0

Sources: SORS and NBS calculation.

* NBS estimate.

Chart IV.5.1 Economic activity indicators
(s-a, H1 2008 = 100)

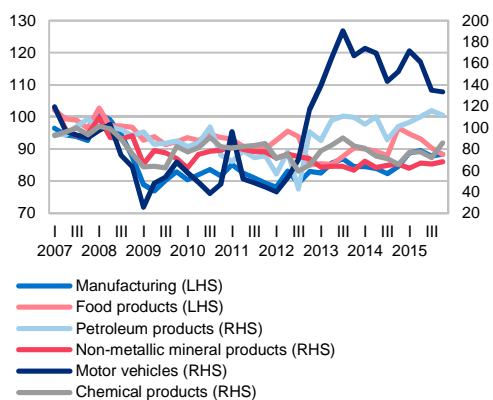


Sources: SORS and NBS calculation.

²³ In Q2, the mining and energy sectors exceeded their pre-flood production levels, hence a slight fall in industrial production was anticipated in Q3.

²⁴ GDP growth in Q1 and Q3 was revised upward by 0.2 pp to -1.8% y-o-y and 2.2% y-o-y respectively, and in Q2 downward by 0.1 pp to 0.9% y-o-y.

Chart IV.5.2 Volume of production by branches of manufacturing
(s-a, H1 2008 = 100)



oil and metal ore output slumped in response to the fall in the prices of these commodities in the international market. Increased coal exploitation also reflected on the higher volume of production in the electricity, gas and steam supply sector (3.6% s-a) which, owing to the upgraded production capacity during flood remediation, outperformed all pre-flood production levels.

The volume of production in manufacturing continued to recede in Q4 (0.5% s-a), though less than a quarter earlier. The decline is mostly attributable to contracted production of food products, precipitated by poorer performance in the current agricultural season. In addition, low oil prices in the international market prompted a fall in the production of petroleum products.

On the other hand, a number of branches within the manufacturing industry recorded an s-a increase in the volume of production, with the highest rise posted in the production of metal products and other manufacturing activities²⁵. The chemical industry also picked up on account of the reopening of closed production facilities which became profitable again owing to the lower price of natural gas. Positive movements continued in the production of base metals as well, where the volume of production in 2015 climbed by 20.6%. After two quarters, the production of motor vehicles also posted growth.

According to our estimates, positive developments in the construction sector extended into Q4 as well (1.9% s-a), growing at a rate close to that in Q3. This is signalled by a rise in the production of construction materials (8.5% s-a) and other construction-related industries (wood processing, furniture production), as well as by the number of issued construction permits which maintained its vigorous y-o-y increase in Q4.

Based on the latest estimates of the Serbian Statistical Office, 2015 saw an 8.0% drop in the volume of agricultural production, pushing GDP down by 0.7 pp. This was primarily induced by the shrunken production of corn (by around 30%) and industrial plants (by around 20%), whereas an upturn in wine growing had the opposite effect (of around 35%). A modest rise in volume terms was also recorded in animal husbandry, which may be linked to the lower price of grain and fodder in the international and domestic markets.

Chart IV.5.3 Volume of production in energy and mining
(s-a, H1 2008 = 100)

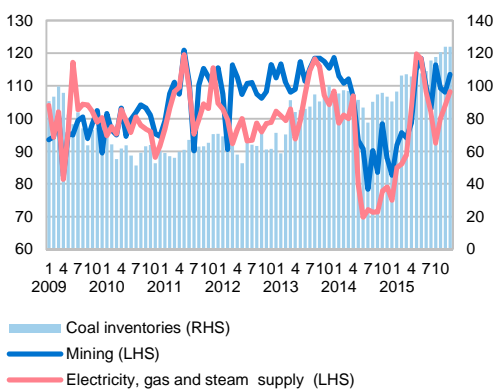
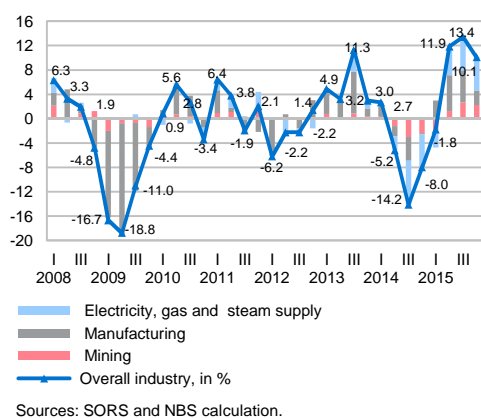


Chart IV.5.4 Contributions to y-o-y growth of the volume of industrial production



²⁵ This includes the production of jewellery, protective and sports equipment, musical instruments, toys, medical materials, etc.

Positive movements in some service sectors continued in Q4. The trade sector activity accelerated, as indicated by the continued growth of 1.6% s-a in retail trade turnover. Also, monthly indicators (number of tourist overnight stays, catering turnover index) point to an extended increase in accommodation and food services, with similar tendencies noted in transport, and information and communications. In view of such movements, we estimate that the contribution of the services sector to the y-o-y growth of GDP in Q4 was positive.

6. Labour market developments

Real net wages in the non-public sector continued to rise in Q4, coming still closer to the level of public sector wages. A rebound in economic activity drove productivity up and, despite a slight rise in real gross wages, helped improve the cost competitiveness of the industry, measured by unit labour costs. The rise in economic activity fed through to the labour market in 2015, leading to higher employment and lower unemployment.

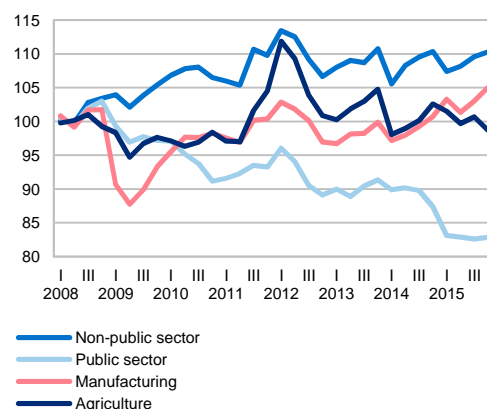
Wages and labour productivity

Nominal net wages recorded a slight increase in Q4 which, coupled with the quarterly fall in prices, drove **real net wages** up by 0.4%. Real net wages rose mostly on account of the increase in non-public sector net wages, while public sector wages also perked up after five consecutive quarters. These movements helped narrow the gap between public and non-public sector wages further down to 3.7% in December.

By sector, real wages in Q4 recorded a rise in manufacturing and the majority of the service sectors. In contrast to previous quarters, real net wages also edged up in government-related sectors (public administration, education, healthcare and social protection). On the other hand, agriculture, construction, mining, electricity supply and real estate sectors paid lower wages relative to a quarter earlier.

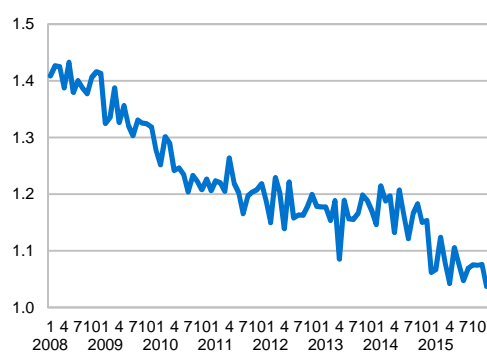
Overall, the y-o-y fall in real net wages (0.9%) continued in Q4. Given the continuing base effect of the cuts in public sector wages, the decline was mostly driven by lower wages in sectors financed from the budget (public administration, education, healthcare and social protection) and dominated by public enterprises (electricity, gas and steam supply and wastewater management). On the other hand, the y-o-y growth in real net wages continued in manufacturing, mining and construction, reflecting increased activity in these sectors.

Chart IV.6.1 Real net wages (s-a, H1 2008 = 100)



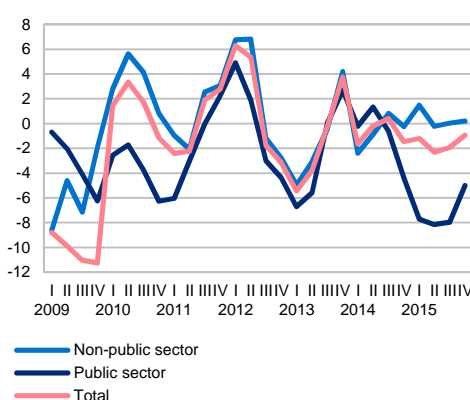
Sources: SORS and NBS calculation.

Chart IV.6.2 Ratio of average nominal net wage in public and non-public sector



Sources: SORS and NBS calculation.

Chart IV.6.3 Real net wage movements (y-o-y growth, in %)



Sources: SORS and NBS calculation.

Chart IV.6.4 Movements in productivity, real gross wages and unit labour costs in industry
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Average nominal net pay in the Republic of Serbia equalled RSD 46,585 in Q4, up by 4.2% from Q3 or 0.5% y-o-y. The real net wage bill also continued to increase (0.4% s-a), though at a slower pace than in Q3. Much the same as in Q3, growth in the real net wage bill was induced by the increase in wages in the non-public sector, while in the public sector the real net wage bill continued to decline.

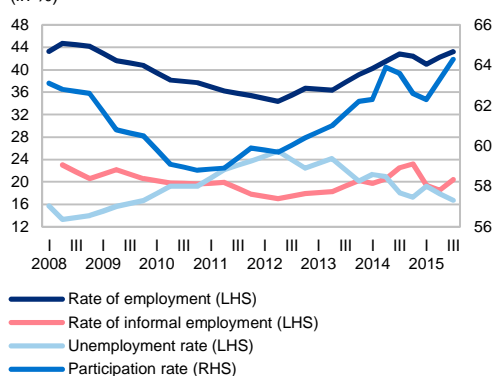
Unit labour costs in industry decreased in Q4 (0.8% s-a), and in doing so, improved the cost competitiveness of the domestic economy. The decrease in unit labour costs was aided by improved productivity (1.5% s-a), induced by higher economic activity and lower employment in the sector of industry, which exceeded a moderate growth in real gross wages (0.7% s-a). Higher cost competitiveness was achieved at the annual level as well, given that unit labour costs were 5.1% lower than in 2014. By contrast, unit labour costs within the manufacturing sector rose in Q4 (1.8% s-a) as productivity gains lagged behind the growth in real gross wages.

Employment

According to the **Labour Force Survey**, labour market continued to paint a brighter picture in Q3. Employment rate improved further – it edged up by 0.9 pp in Q3 and by 0.4 pp y-o-y. Employment figures rose amid higher rates of participation²⁶, which climbed by 1.0 pp to 64.3%. Informal employment also inched up by 1.9 pp in Q3, though it was still 2.1 pp lower than in the same period last year. This can be partly explained by higher use of seasonal labour in agriculture and construction, as this is most often done without a formal employment contract. The impact of the seasonal component on the rise in employment is further illustrated by the higher number of persons working part-time or on fixed-term contracts. A breakdown by sector shows that in Q3 employment rose in agriculture, industry and construction, and decreased in the services sector.

Q3 saw the jobless rate decline even further to 16.7%, down by 1.2 pp from Q2 and by 1.4 pp in y-o-y terms. This was achieved mostly owing to a fall in youth unemployment, which dropped below 40% (38.8% in Q3) for the first time since the crisis began. As for long-term unemployment, the share of persons seeking job for

Chart IV.6.5 Labour market indicators under the Labour Force Survey
(in %)



Source: SORS.

²⁶ Participation rate measures the share of active population in total population of working age (aged 15–64).

longer than one year in total unemployment figures perked up by 2.0 pp to 67.3%.

In September 2015, the Serbian Statistical Office switched to a new methodology for monitoring formal employment which relies on processing **data obtained from the Central Registry of Compulsory Social Insurance** and the Statistical Business Register, rather than on the previously used RAD survey. Formal employment statistics should thus be improved in terms of the scope of data reported because under the new methodology, employment figures also include persons working under Special Services Contracts and Contracts on Temporary and Periodic Work, plus those employed in the Ministry of Defence, Ministry of the Interior and the Security Information Agency. Given that these data will be obtained from the Registry, the impact of statistical and sampling errors, which may occur when evaluating data obtained through surveys, will now be reduced.

According to these data, formal employment dropped by 1.0% in Q4 mostly because of a decline in employment with legal persons, while a smaller contribution to the decline came from a drop in the number of individual farmers. In contrast to that, the number of private entrepreneurs and their employees went up. A quarterly fall in employment figures was recorded across sectors. Nevertheless, it should be noted that the data obtained from this source are treated as preliminary, i.e. that they are subject to adjustment after additional verification.

In annual terms, formal employment in 2015 ticked up by 0.4% owing to the increased number of entrepreneurs and their employees (4.7%). Employment with legal persons was marginally lower relative to end-2014, while a somewhat bigger drop in employment was recorded for individual farmers (3.9%).

National Employment Service data confirm that the jobless rate continued to decline in Q4. Total unemployment equalled 724,026 persons in December, down by 11,862 from September and by 17,810 from the start of the year. Unemployment recorded a fall across all occupation groups, most notably in machinery and metal processing, and trade, catering and tourism. The number of persons receiving unemployment benefits dipped further down in Q4 (by 2,922 persons relative to Q3) and equalled 45,162 persons at end-December.

Table IV.6.1 Movements in formal employment and unemployment

(quarterly growth rates, end-of-period)

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

Sources: SORS and National Employment Service.

7. International environment

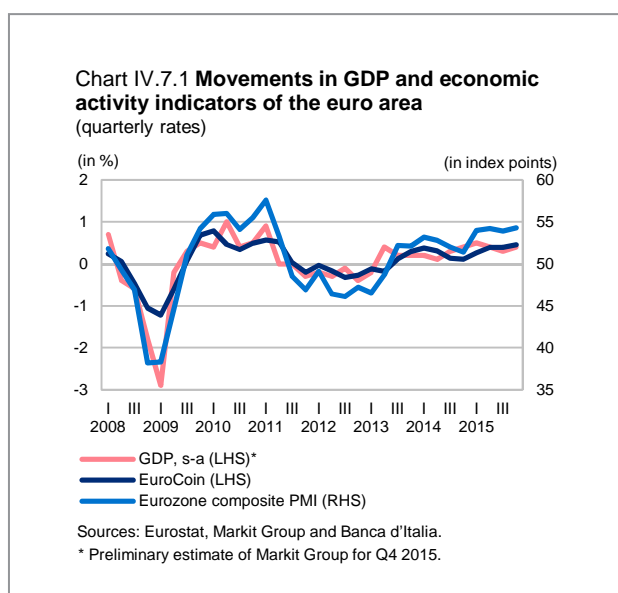
Due to the likely slowdown in some of the emerging economies weighing on prospects for global growth, the IMF revised its latest forecast downwards. The fear of a global slowdown reflected on higher risks regarding the economic performance in other countries. Data indicate that the euro area GDP was driven by domestic demand in Q3. The global slowdown and the strengthening of the dollar, in case of the USA, reflected in a negative contribution of net exports. Economic activity stepped up in most Central and Eastern Europe countries owing to the ECB's accommodative monetary policy and low oil prices.

Central banks in developed countries continued to battle with low inflation, closely monitoring the impact of a new drop in global oil prices, effects of a slowdown in emerging countries and the exchange rate trends. In December, the ECB eased its monetary policy further, only to hint the very next month at the possibility of additional stimulus in March. As the Fed began its policy normalisation in late 2015, the uncertainty now concerns the timing and size of the Fed's policy rate hikes in 2016, which will largely shape trends in the commodities and financial markets, and determine capital flows towards emerging economies. Uncertainties in the international environment are also fuelled by volatilities in the financial market, China's slowdown and strong geopolitical tensions.

Economic activity

In Q3 as well, household consumption stayed the key driver of **GDP growth in the euro area**, measuring 0.3% in s-a terms. The increase was brought about by higher real disposable household income on the back of favourable trends in the labour market and lower oil prices. On the other hand, net exports were a negative contributor due to the slowdown across emerging markets.

Based on the leading indicators of economic activity, it is estimated that GDP in the euro area will pick up slightly in Q4 (0.4% s-a, according to December Consensus Forecast and the latest Markit Group estimate). In December, the composite index of economic activity in the euro area (PMI Composite) reached its highest level since May 2011 (measuring 54.3 points). The Economic Sentiment Indicator also rose in Q4, measuring 106.8 points in December, thus reaching its highest level since March 2011. As labour market conditions continued



improving in the closing quarter of the year, the unemployment rate dropped to 10.4% in December, falling 1.0 pp in y-o-y and 0.2 pp in q-o-q terms.

Assuming further growth in Q4, GDP in the euro area is expected to grow 1.5% in 2015. According to the IMF, the year 2016 should see this growth inch up to 1.7%, which is in line with the ECB’s and Consensus Forecast estimate. It is expected that such higher pace of growth will be fuelled by a positive contribution of investment facilitated by favourable borrowing conditions and recovery in corporate profits. At the same time, a strong positive contribution is expected to continue from private consumption, which will be shaped by the same favourable factors as in 2015. The contribution of net exports is expected to be neutral as the effects of the euro’s weakening and further growth in the USA and other developed economies will be offset by the slowdown across emerging economies and the growth in imports powered by higher final consumption.

Economic activity in the **USA** slowed down to 0.5% s-a in Q3, chiefly due to a decline in inventories and slower rise in exports caused by the dollar’s strengthening and weaker demand for exports. The most substantial positive contribution again came from final household consumption and to a lesser extent from fixed investment and government consumption.

The preliminary estimate suggests that growth in the US GDP further decelerated to 0.2% s-a in Q4, with the positive contribution from final household consumption continuing, although at a lesser intensity relative to Q3. Positive contribution from government consumption and fixed investment weakened, while net exports, due to the drop in exports, were a negative contributor. Household consumption was propelled by the labour market recovery, as indicated by a drop in unemployment rate to 5.0% in December and the average monthly increase in new nonfarm payroll employment of 220,000 in 2015. Also, lower oil prices, low inflation, favourable borrowing conditions and a rise in real estate prices and stock exchange indices pushed up the consumer confidence index by around 10% on average above its level in 2014. Dollar surging against other world currencies and global slowdown will negatively affect net exports, while low oil prices could cause activity and investment in oil exploitation and processing to drop. Consequently, the latest 2016 GDP growth projections have been revised slightly downwards (by 0.2 pp) – the IMF now estimates GDP will grow by 2.6% and the January Consensus Forecast by 2.4%.

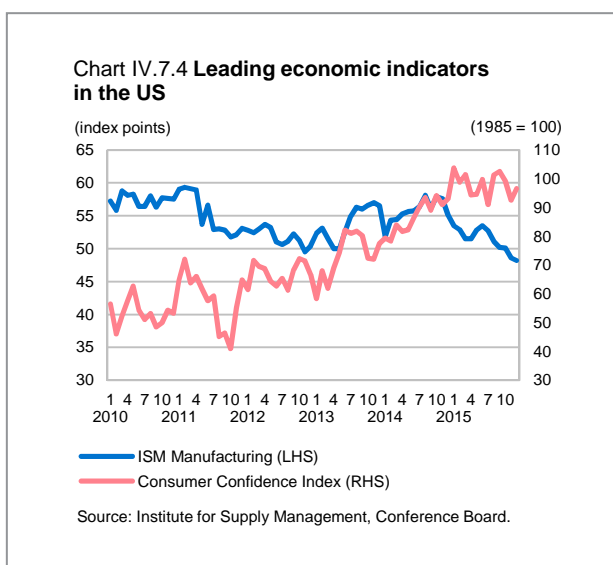
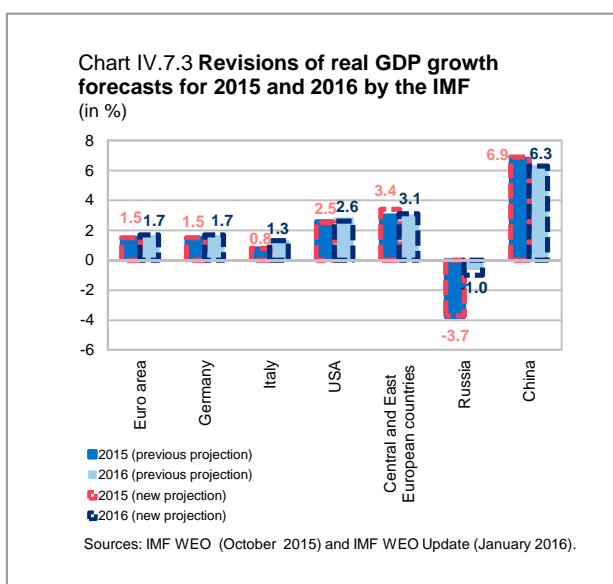
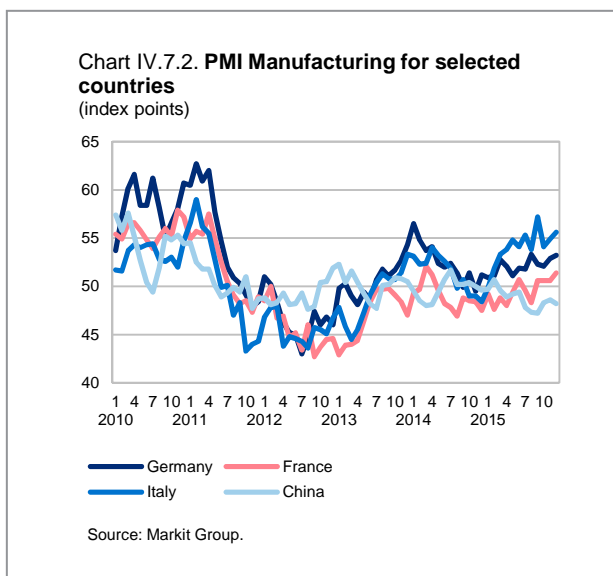
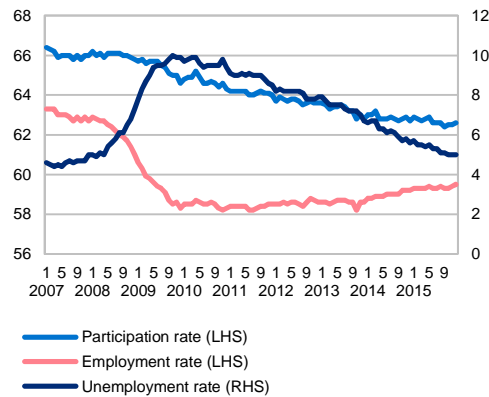


Chart IV.7.5 US labour market
(monthly rates, in %)



Source: Bureau of Labor Statistics.

Table IV.7.1 Economic growth estimate
by country
(in %)

	Consensus Forecast		IMF	
	January 2016		October 2015	
	2015	2016	2015	2016
Poland	3.5	3.5	3.5	3.5
Czech Republic	4.5	2.6	3.9	2.6
Hungary	2.7	2.3	3.0	2.5
Albania	2.7	3.3	2.7	3.4
Bulgaria	2.8	2.6	1.7	1.9
Bosnia and Herzegovina	2.7	2.9	2.0	3.0
Macedonia	3.3	3.8	3.2	3.2
Montenegro	-	-	3.2	4.9
Romania	3.7	4.0	3.4	3.9
Slovenia	2.6	2.1	2.3	1.8
Croatia	1.6	1.5	0.8	1.0

Sources: Consensus Forecast and IMF.

GDP growth in **Central and Eastern Europe** continued at a relatively brisk pace in Q3, owing primarily to countries of Central Europe whose economies are most tightly linked to the euro area. In most of these countries, growth was driven primarily by private consumption, which was stimulated by a rise in real disposable income, similarly as in the euro area. In the Czech Republic, Poland and Romania, it was investment, in addition to private consumption, that also gave a significant contribution to growth, so these countries posted the highest growth rates in Q3 in the region (4.5%, 3.7% and 3.6% y-o-y, respectively). GDP growth sped up in most of Southeast Europe in Q3, owing to domestic demand, as well as net exports that were driven by low oil prices and further economic recovery of their main foreign trade partner (the euro area).

Despite political uncertainties and the vicinity of geopolitical conflicts, economic activity in Turkey kept its relatively vigorous growth (0.4% y-o-y), driven mainly by final government and household consumption. On the other hand, Russia's GDP went deeper down (by 4.1% y-o-y in Q3) because of the further drop in oil prices and the extension of economic sanctions imposed by Western countries, while high inflation and falling budgetary revenues lessened the chances of a more accommodative monetary and fiscal policy. It is estimated that Russia's GDP will decline amid such conditions, which will negatively reflect on other countries in Central and Eastern Europe which have lucrative trade relations with Russia.

According to Consensus Forecast, prospects for the 2015 GDP growth in Central and Eastern Europe are slightly better than under the October projection, so estimates now indicate stagnation. Under the latest IMF estimate, growth prospects for the region of Central and Eastern Europe (excluding Russia, Ukraine and the euro area members from this region), have been revised upwards by 0.4 pp to 3.4%. The region of Central and Eastern Europe is expected to continue the trends of relatively stable growth in 2016 (3.1%, as suggested by the IMF). Major challenges could include geopolitical tensions building further up and the Fed's monetary policy becoming less accommodative, which could affect capital inflows.

China's slowdown, caused by its adjustment to the new growth model, lasted into Q4 which saw GDP growth of 6.8% y-o-y. Total GDP growth in 2015 was the lowest in the last 25 years, and measured 6.9%, in line with the official target of the Chinese government of

approximately 7%. GDP growth was chiefly driven by final consumption, as confirmed by higher retail trade turnover. Although positive, fixed investment gave weaker contribution than a year earlier. Observed from the production perspective, this growth was propelled by the services sector. On the other hand, sectors that used to drive China’s domestic growth and had a significant sway on global demand (industry and construction) were weaker contributors this time around. Slower GDP growth is also expected in 2016 (with growth rate projected at 6.5%, similarly to the IMF estimate of 6.3%), given that the existing surplus of production capacities will continue to put a drag on investment and industry growth.

Slower growth in China and further drop in prices of oil and other commodities reflect on slower economic growth and recession in some of the emerging countries – net exporters of oil, base metals and primary agricultural products. This spills over onto global economic trends via trade and financial channels, and that is the primary reason why the global growth forecast was revised downwards by 0.2 pp, according to the latest IMF projection.

Inflation movements

Inflation dynamics in **the euro area** in Q4 was again weaker than expected. Despite the ECB monetary stimulus, prices rose by 0.2% y-o-y in December, following two consecutive months of 0.1% y-o-y growth. December inflation was lower than anticipated, primarily due to a new drop in the already low oil prices, and weaker rise in prices of food and services. Trends recorded in early 2016 do not call for optimism either, as further drop in oil prices prevented a rise in inflation which could have happened owing to the low base effect. Judging by the January oil futures prices, significantly lower than in early December, the ECB expects inflation in 2016 to trend below the figures projected in early December. Inflation rates are likely to stay quite low or negative in the following months, yet are expected to rise in late 2016 and in 2017. According to the results of the quarterly Survey of Professional Forecasters, published by the ECB in January, short-term inflation expectations have dipped, just as in the October survey. This time, however, mid- and long-term inflation expectations also dropped (unlike in the previous survey when they stayed unchanged). January also saw long-term market inflation expectations fall to their lowest in the previous year. These figures show five-year ahead inflation the market expects in the euro area five years from now (in the year 2021 for the year 2026).

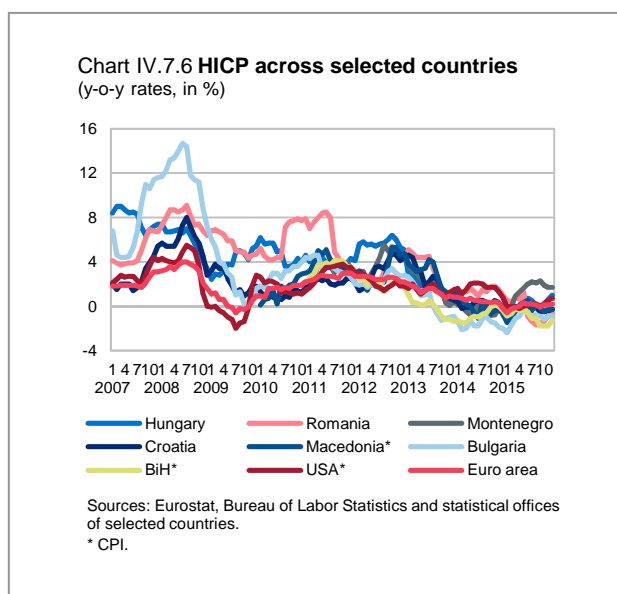
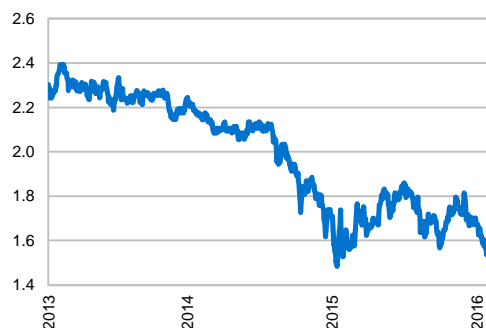
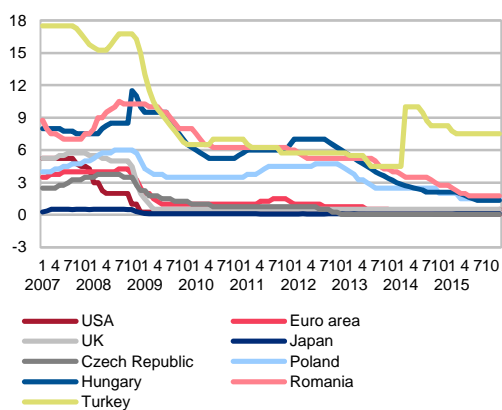


Chart IV.7.7 Long-term inflation expectations in the euro area (in %)



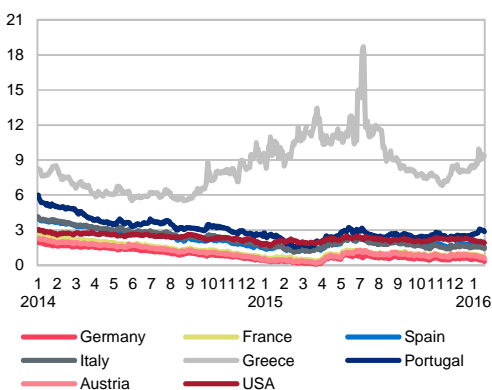
Source: Thomson Reuters.

Chart IV.7.8 Policy rates across selected countries (annual level, in %)



Sources: Central banks of selected countries.

Chart IV.7.9 Yield on 10-year bonds of selected countries (daily data, in %)



Source: Bloomberg.

Low and negative inflation persisted in most **Central and Eastern European** countries. As in the previous quarter, negative inflation rates were most pronounced in Bosnia and Herzegovina, Romania and Bulgaria which has been facing deflation for two years now. During Q4, prices dropped in Croatia and Macedonia. Consumer prices rose moderately in Hungary and Montenegro. Due to strong depreciation of their currencies, Russia and Turkey still face significant rise in prices.

Although inflation in the USA rose gradually throughout Q4, coming to 0.7% y-o-y in December, it remains low and trends below the long-term target of 2.0%. Low inflation is primarily the result of lower energy prices and the dollar's strengthening that pulled down imports prices. The Fed expects inflation to stay low in the short run, but to rise gradually as effects of the drop in energy prices and imports prices wear off, and as the labour market recuperates further.

Monetary policy

The **ECB** realised that numerous conventional and unconventional monetary measures it had been implementing since June 2014 failed to fully meet the expectations, particularly with respect to inflation. In its December 2015 meeting, the ECB therefore decided to cut the interest rate on the deposit facility by 0.1 pp to -0.3% and to extend its QE programme at least until March 2017 (previous deadline was September 2016). Information from the early 2016, mainly about the new drop in global oil prices and the effect of emerging countries' slowdown, prompted the ECB already in January to announce the possibility of new monetary stimulus in March so as to ensure economic recovery and help bring inflation back on target.

Even though inflationary pressures are low in **Central and Eastern European countries**, the central banks mostly ended their monetary easing programmes, and did not change their key rates in Q4.

As most market participants expected, the **Fed** began normalisation of its monetary policy in mid-December, increasing its policy rate by 0.25 pp for the first time since 2006, so the policy rate now moves within the 0.25-0.50% range. This decision is primarily the result of favourable data from the labour market, particularly data on the newly created jobs which exceeded all expectations. Although economic growth slowed down late last year, the Fed believes that modest growth will continue in 2016, and that inflation will rise in the long run, owing chiefly to higher demand. According to the

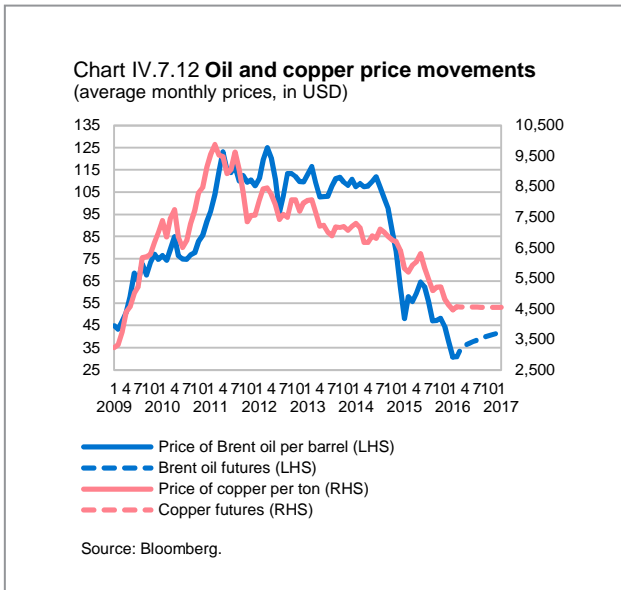
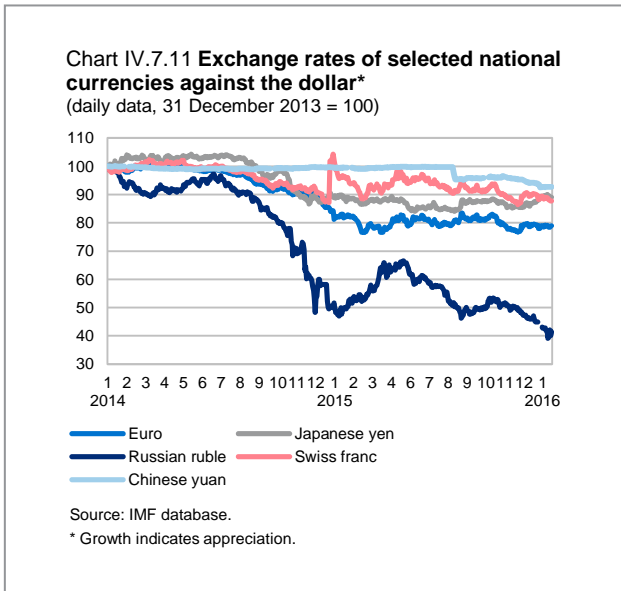
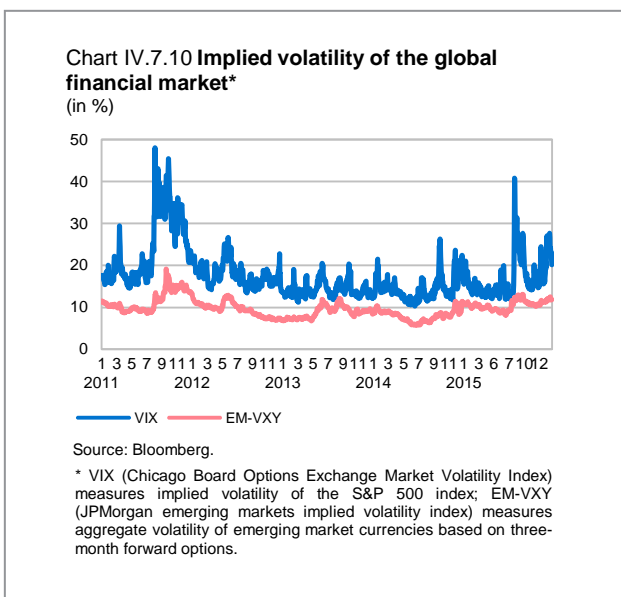
futures contracts data, the market has drastically reduced its expectations of the policy rate being increased in March. The market participants were prompted by the trends around the turn of the year, the new drop in oil prices in particular. The market now believes that this increase will not happen before June. The January drop in yields on ten-year government securities also speaks of the fear that economy and global conditions may be weaker.

Financial and commodity markets

Greater instability in financial and commodity markets marked the turn of the year. Market participants focused mostly on **China's** economy due to its effect on global demand and economic growth. The uncertainties primarily concerned the three key segments. The first segment is China's real sector, with weaker than expected results. The second segment is the general state in the foreign exchange market due to the yuan's depreciation. The third segment means trends in stock exchanges, not so much because of their importance as a source of funding, but more as an indicator of economic growth prospects. Weaker results in all of these segments sent shocks across the international financial market. The uncertainty in the financial market is indicated by fluctuations in VIX, tracking the S&P 500 index options, which ranged between 14% and 28% during the review period.

During Q4, market participants also focused on the Fed. However, as the policy rate hike was expected, it was mostly already incorporated in market's decisions. The **dollar** consequently grew stronger against the **euro**, but only until the beginning of December, when the ECB took the market by surprise, easing its policy less than expected, which drove the euro sharply upwards against the dollar. Afterwards the exchange rate of these two currencies was relatively stable. The divergent monetary policies pursued by the Fed and the ECB will primarily determine the dollar and euro trends in the period ahead.

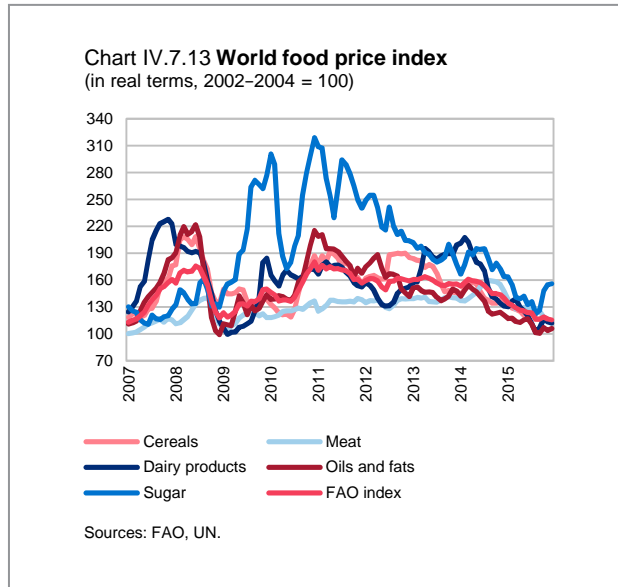
The new drop in global **oil** prices is a consequence of both demand and supply. Oil price decline in January 2016 to USD 27 per barrel (compared to USD 115 per barrel in June 2014) was also brought about by oversupply mostly in OPEC countries. The biggest exporter, Saudi Arabia, is not reducing its production. In addition, oil inventories are still high in the USA which did not scale down their production either, or at least not to the extent which could actually put upward pressure on prices. Given lower demand and Iran's entering the oil market that is already



oversupplied by OPEC countries, oil prices are expected to stay low throughout 2016.

Also, prices of other primary products, **base metals** in particular, have dropped. China's economic activity plays a more significant role in the metal markets, than in the oil market. Over the last 15 years, China's share in global consumption of these metals rose from 10% to over 50%. As the demand for metals is likely to stay low, their prices are not expected to recover in the near future.

Having risen shortly in October, **world food prices, measured by FAO index**, dropped in the following two months. In Q4, they declined 0.8% in real terms from a quarter earlier. At the level of the year 2015, which marked the fourth consecutive year of decline, world food prices were lower in real terms by 18.9% relative to 2014. Modest global demand amid large inventories and strengthening of the US dollar were the main reasons for low food prices in 2015. Observed by food category, prices of meat and cereals dropped in Q4, while prices of dairy products, edible oil, and above all sugar, rose. Nonetheless, at year level prices across all food categories were significantly lower than in 2014.



Text box 5: Current risks from the international environment

In a globalised world, macroeconomic projections of central banks are always exposed to external risks. These risks intensified around the turn of the year, becoming the main risk to the projections, especially in small and open economies such as ours. Current trends in international financial and commodity markets confound most market participants, supporting the fact that it has become extremely difficult to predict not only the intensity of the change, but also its direction. Present economic and geopolitical risks further increase the likelihood of quick and sudden movements in almost all markets. Therefore, caution is advised in formulating monetary policy and economic policy in general. For this reason, the NBS, along with the majority of central banks, emphasises that monetary policy in the coming period will be influenced primarily by events in the international environment and the assessment of their inflationary effect. The question is, which events make global financial flows and the conjuncture so uncertain?

Firstly, uncertainties surround **the movement of economic activity of China and other emerging markets, and the effect it will have on global economic activity**. While in the previous years the Chinese economy acted as a counterbalance to the recession in advanced economies, its growth is now slackening. The sensitivity of investors to economic trends in China stems from the fact that China's share in global GDP is now higher than that of all Asian countries hit by the 1998 crisis. Worries about a weaker outlook for growth give rise to uncertainty and turmoil in Chinese stock exchanges, and cause capital outflows, depreciation pressures and a fall in FX reserves (by over USD 100 bln in December 2015 alone). The Chinese economy can be stimulated by additional measures for monetary and fiscal expansion only to a certain extent, due to fears that the exchange rate might continue to weaken. Currency depreciation itself would fail to significantly stimulate exports because of their high dependence on imports; instead, it would additionally encumber the already stretched balance sheets of companies with US dollar-denominated debt and drive some of them into bankruptcy.

Given their size and integration in the global economy, a synchronised slowdown of other large emerging economies, notably other BRICS countries (in addition to China, these include Brazil and Russia, which are already in recession, and India and South Africa), could exert a considerable global impact through trade and financial flows. According to World Bank estimates, a decrease in economic growth of BRICS countries by 1 pp in the next two years would reduce growth by 0.8 pp in other emerging economies, by 1.5 pp in frontier markets, and by 0.4 pp in the global economy at large.¹ Expecting deceleration in emerging economies, the IMF revised its global growth projections downward in January.

The current situation, characterised by low prices of primary commodities and the strengthening of the US dollar, is not conducive to the growth of emerging economies. It is, however, difficult to estimate to what extent these economies will slow down. Many of them achieved significant structural improvements in the last 15 years and reduced their internal and external imbalances. For this reason, some analysts believe that this year investors could be surprised by better than expected economic performance of these countries. Bad news from emerging economies may already be incorporated in market decisions, and the MSCI EM², which dropped by 20% over the last six years (while S&P 500, relevant for the performance of advanced economies, rose by 40%), could possibly start growing. Given its trade surplus, inflow of FDIs and FX reserves worth USD 3.3 trillion, China is believed to be far from a crisis in the true sense of the word.

Towards the end of 2015, the price of oil started falling again, down to below 30 dollars per barrel in January 2016 (its lowest price since 2003). Also, the already low prices of other primary commodities fell further. This new fall greatly surprised the market and increased **uncertainty over the future movement of prices of primary commodities, notably oil**. As regards the situation on the supply side, in their December meeting, the OPEC member countries refused to adhere to quotas, while Iran's production and exports, now that the sanctions are lifted, are unknown (although maximum production was announced, estimates suggest it will take some time to replace the technology made obsolete during sanctions by importing new technology). The oil market is already oversupplied; last year, even the supply of high-cost producers grew, since no matter how much the price of oil fell, it still exceeded operating costs. Global oil inventories are at record highs and are not expected to decline before H2 2017. In addition, the price of oil may be more dependent on the

¹ Global Economic Prospects, January 2016, World Bank.

² Morgan Stanley Capital International Emerging Market Index.

movement of demand. The expected slow growth of China could drive demand down considerably. Demand could also be weighed down by a continued depreciation of the yuan, which would further depress it through higher prices of imports. The data already show that Chinese oil demand has been weakening since last summer. In addition, oil demand could decline in other countries, which fuels uncertainty regarding both its global trends and the oil price movements. This uncertainty is illustrated by the January American derivatives contracts tied to deliveries in April, with prices ranging from USD 25 to 56 per barrel. According to the International Energy Agency, the balancing of oil demand and supply will not take place before 2017. Given the low prices of oil and other primary commodities, and the global economic slowdown, it is quite likely that **global inflation** will remain extremely low in 2016.

How the Fed's monetary policy normalisation will evolve is another question to be answered. As most market participants expected, the Fed began normalisation of its monetary policy in mid-December, increasing its policy rate for the first time since 2006.³ This question primarily concerns the timing and size of the Fed's policy rate hikes. This is particularly important for emerging economies, as it will largely shape global liquidity and capital flows. According to the futures contracts data, the market has drastically reduced its expectations of the policy rate being increased in March. The market now believes that this increase will not happen before June, due to weaker than expected economy and global trends. Also, some analysts assess the Fed's December increase as hasty, believing that the rate may be returned to the previous level, as was the case with the ECB's rate in 2011. According to these analysts, while the nonfarm payroll employment in December exceeded all expectations, the job market remains weak, as does production (the PMI was below 50 for two consecutive months, indicating a contraction). The prospects of slower economic recovery reflected on lower **yields on government securities**.

Greater external risks could challenge **the pace of the euro area recovery**. Having in mind the new drop in global oil prices, effects of the slowdown in emerging economies and foreign exchange trends, the ECB eased its monetary policy further in December. The very next month, it announced the possibility of introducing new accommodative measures in March, when new projections become available, which will include the year 2018 as well. The ECB's decisions are particularly important for Serbia – euro area is our most important trade partner, and the ECB's accommodative measures lessen the negative effects of the Fed's monetary policy normalisation. It is expected that the divergent monetary policies pursued by these two central banks will determine **the dollar and euro trends** in the period ahead. Higher interest rates in the USA should encourage investors to purchase dollars, more so because the ECB and the Bank of Japan are going to keep their policy rates near zero. However, is the dollar's strengthening such a likely scenario? Could the dollar weaken rather than rise in the period ahead? Some analysts believe that the dollar has already strengthened significantly, so it could be that higher interest rates are already priced in. It also remains to be seen whether the degree of policy accommodation will be reduced in line with the Fed's projections or less restrictively.

These external risks affect inflation and economic activity in Serbia through various channels simultaneously, some of which act upwards and other downwards. It is therefore difficult to assess their overall effect. Weaker prospects for global growth may lead to lower inflation and economic activity in Serbia via trade. They may also further lessen the cost-push pressure on inflation through low prices of primary commodities, chiefly oil. On the other hand, the drop in oil prices may push up inflation and economic activity via higher disposable income and demand. The Fed's policy normalisation and the ensuing negative global financing conditions may adversely affect capital flows towards emerging economies, Serbia included. Also, any sudden rise in global risk aversion, regardless of its cause, could lead to lower capital inflows and higher risk premium and affect the exchange rate.

Given these growing external risks, the NBS intends to closely monitor trends in the international environment. It is going to adopt policy measures mindful of their effects on our economy. As so far, the NBS plans to use all available instruments to keep inflation low and stable, which, along with the financial system stability and a relatively stable exchange rate, is a prerequisite for accelerated, but sustainable economic growth. The results in the area of fiscal consolidation, sustainability of public finances, improvement of business and investment environment, and the reduction of external imbalances will help lessen the effect of any external shocks.

³ The normalisation process is expected to last around seven years. In addition to increasing its policy rate, the Fed intends to end "reinvesting" and gradually reduce the assets in its balance sheet as securities mature (the Fed currently does not plan to sell its assets, although such an option cannot be ruled out).

V. Inflation projection

Having been on a downward path for an extended period of time, y-o-y inflation is projected to rise moderately from mid-2016 and make its way back within the target band late this or early next year. We estimate that its growth will continue in 2017, though at a much slower pace, averaging around 3.0%. Inflation growth will reflect gradual weakening of disinflationary pressures amid expected rise in international primary commodity prices, aggregate demand in Serbia and inflation abroad. The risks to the projected inflation path are associated primarily with external factors, i.e. future developments in the international commodity and financial markets.

GDP is projected to step up from 0.8% in 2015 to 1.8% in 2016 and 2.2% in 2017. Like last year, GDP growth is expected to be led mainly by investment.

The medium-term inflation projection aims to show the expected inflation movements (CPI), the main factors behind such movements and the underlying risks. It is expressed both as a range for the CPI and as a central projection rate. This projection assumes an active monetary policy which aims to keep inflation within the target tolerance band in the medium run and thus fulfil its principal role as defined by the current monetary policy framework.

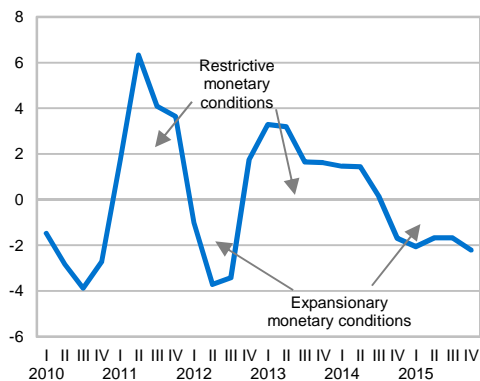
Initial conditions

Consistent with the expectations stated in the November *Report*, y-o-y inflation continued below the lower bound of the target tolerance band ($4.0 \pm 1.5\%$) in Q4 and amounted to 1.5% in December. Inflationary pressures remained subdued, as a result of the majority of domestic factors, as well as low international prices of primary commodities and generally low inflation abroad. Core inflation (CPI excluding food, energy, alcohol and cigarettes), which has been running below the target tolerance band since August 2014, equalled 1.6% y-o-y in December.

Q-o-q, consumer prices inched down by 0.5% in Q4. The biggest drag on consumer prices came from unprocessed food and petroleum products (contributions of -0.7 pp and -0.3 pp respectively), while the strongest impetus originated from industrial products excluding food and energy (0.5 pp contribution).

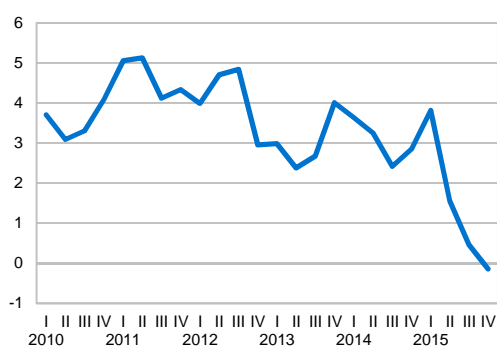
Extended period of low inflation and anticipation of weak inflationary pressures in the period ahead have helped

Chart V.0.1 Monetary conditions index (in %)



Source: NBS.

Chart V.0.2 Real interest rate* (in %)



Source: NBS.

* Real interest rate was obtained as a difference between one-week BELIBOR and one-year ahead inflation expectations of the financial sector under the Bloomberg survey.

anchor inflation expectations within the target band. In fact, both one- and two-year ahead inflation expectations of the financial sector and businesses stand below the target (4.0%).

The exchange rate of the dinar was relatively stable in 2015. While appreciation pressures prevailed over much of the year, those in the opposite direction built up in Q4 and early 2016. Depreciation pressures were most pronounced in the first half of December when, in anticipation of the onset of the Fed's monetary tightening, foreign investors started reducing their exposure to emerging markets, Serbia included. On the other hand, surging FDI, successful completion of the third review under the stand-by arrangement with the IMF and Serbia's improved credit rating outlook (Fitch) paved the way for a reduction in the country's risk premium (measured by EMBI) in Q4. In January, downward pressures on the dinar were caused by seasonal factors and turmoil in the international financial markets, which reflected also on the rise in the risk premium. In order to ease excessive daily volatility of the exchange rate, the NBS intervened in the IFEM in Q4 by both buying (EUR 110.0 mln) and selling foreign exchange (EUR 320.0 mln), whereas in January it intervened on the sale side only (EUR 290.0 mln).

Based on the Monetary Conditions Index, the monetary policy stance has been expansionary for more than a year now, which is appropriate given the ongoing disinflationary pressures and open negative output gap. The expansiveness of the monetary conditions in Q4 is suggested both by the widening of the depreciation gap of the real exchange rate (due to the nominal depreciation of the dinar against the euro) and by the real interest rate²⁷ (given that the reduction of the key policy rate drove the real interest rate significantly below the neutral level, pushing it in Q4 into the negative territory for the first time).

Consolidated budget deficit increased in Q4 as a result of seasonal factors and the use of fiscal revenue over-performance for the execution of one-off expenses to regulate past government liabilities. At year level, however, the deficit stayed below the ceiling envisaged by the agreement with the IMF (RSD 163.8 bln)²⁸. Namely, it amounted to 3.7% of GDP and was by nearly 3.0 pp lower than in 2014. At the same time, the primary

²⁷ Real interest rate is derived as the difference between one-week BELIBOR and one-year ahead inflation expectations of the financial sector measured by Bloomberg.

²⁸ Consolidated budget deficit was initially projected at RSD 232.1 bln, but was later on revised down in light of ongoing fiscal developments.

deficit amounted to no more than 0.5% of GDP. A major part of the 2015 savings may be attributed to the cut in pensions and public sector wages, but also to improved tax collection. Having in mind that a further reduction in the share of consolidated budget deficit in GDP should rely more on savings resulting from structural adjustment, which in the short-term entails certain costs, we estimate that this share will stay broadly unchanged in 2016 and that it will continue down in the years to follow.

Based on NBS estimate, Serbia’s GDP grew by 0.2% s-a in Q4 and was spurred by domestic demand, notably investment, which also played an important role in GDP growth at year level. Net exports, on the other hand, provided a negative contribution to GDP growth in Q4 because of a somewhat faster increase in imports of intermediate goods. On the production side, GDP growth was led by industrial production and construction. The fact that activity stepped up in the majority of manufacturing industries is a positive signal.

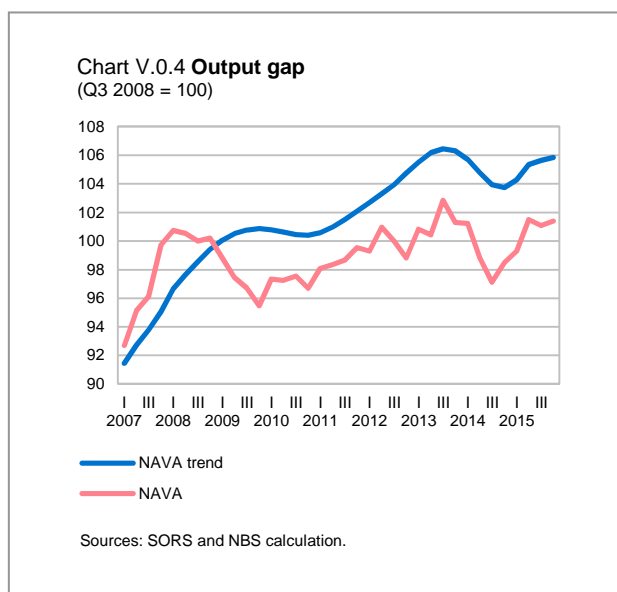
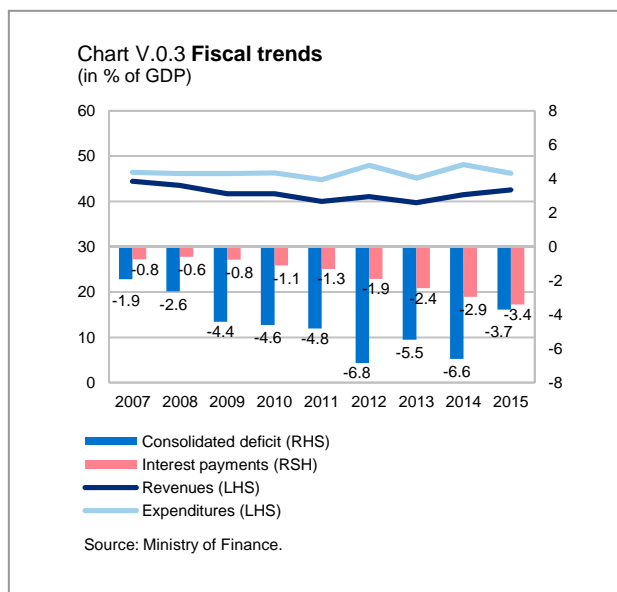
The economic upturn in Q4 has induced a negligible narrowing of the negative output gap²⁹, which means that the intensity of disinflationary pressures from aggregate demand remained almost unchanged from Q3.

After 0.3% s-a growth in Q3, economic activity indicators suggest that the euro area’s GDP continued growing at a similar pace in Q4. The recovery of the euro area is supported by low oil prices and the accommodative monetary policy stance of the ECB which decided in December to cut the deposit rate further (to -0.3%) and to extend the stimulus programme until March 2017 or beyond if necessary. The Fed, on the other hand, started the previously announced rate hike in December. However, the dynamics of rate hikes could be somewhat slower than anticipated earlier, given the financial market volatility and downside risks to US inflation stemming from lower oil prices and stronger dollar.

Inflation projection assumptions

External assumptions

Standing at 1.7%, the current assumption for the euro area's GDP growth in 2016 matches its November counterpart, whereas a similar rate of growth is expected



²⁹ Output gap is calculated based on NAVA (GDP less agricultural production and net taxes). NAVA trend estimated by the Kalman filter is used as an approximation of potential output.

Table V.0.1 **Projection assumptions**

(changes relative to the previous projection are given in brackets)

	2016	2017
External assumptions		
EU inflation	0.8% (-0.3)	1.5%
ECB policy rate (year-end)	0.05% (-)	0.05%
Euro area GDP growth	1.7% (-)	1.7%
International prices of primary agricult. commodities (Q4 to Q4)*	3.0% (-3.0)	3.0%
Brent oil price per barrel (year-end, USD)	40.0 (-15.0)	44.0
Internal assumptions		
Administered prices (Dec to Dec)	3.9% (-1.0)	4.0%
Trends		
Appreciation trend of the real exchange rate (average)	0.7% (-0.6)	0.9%
Real interest rate trend (average)	1.8% (-0.7)	1.4%

* Composite index of soybean, wheat and corn prices.

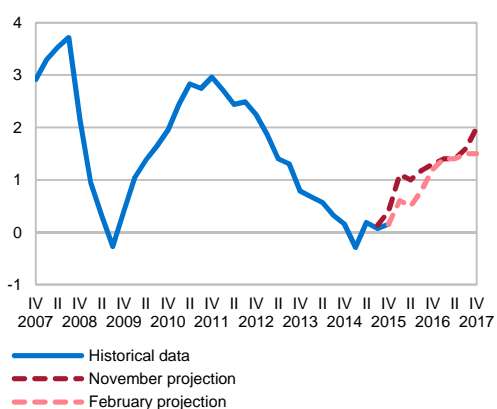
Source: NBS.

in 2017 as well.³⁰ Domestic demand in the euro area will continue to be supported by monetary policy measures and the resulting improvement in financial conditions, progress in the implementation of fiscal consolidation and structural reforms, as well as by lower oil prices which have a positive effect on real disposable income of households and the reduction of costs for businesses. On the other hand, downside risks to these projections are associated with an increasingly uncertain outlook for emerging markets' growth, which could weigh down the demand for euro area exports, as well as with financial market volatility and geopolitical tensions. In addition, the euro area has for some time been faced with the tepid pace of structural reforms and the need for balance sheet adjustment across a number of sectors, which could slow down its recovery in the medium term.

After falling into the negative territory in September, y-o-y inflation regained some ground in Q4, but stayed close to zero, measuring 0.2% in December. Inflation will remain low over the coming months, but is likely to rise thereafter propped up by the ECB's monetary policy measures and further economic recovery of the euro area. This rise is expected to continue in 2017. Consistent with the announcements of ECB officials and the extension of the stimulus programme, the markets expect no change in the ECB's key interest rate over the coming twelve months (Consensus Forecast).

Though fluctuating, international prices of primary agricultural commodities (corn, wheat, soybean)³¹ showed a slight downward trend in the last four months, sustaining relatively low food production costs. While the assumption for international prices of primary agricultural commodities has been revised down relative to the November projection, we expect these prices will, in line with commodity futures, rise modestly from their current low levels.

Oil prices³² have plummeted by more than 40% since October, marking the greatest departure from the assumptions underlying the previous projection. Namely, following a short-lived rally in early October, when they overshot USD 50 per barrel, oil prices dipped yet again due to the oversupply which shows no sign of abating. Oil

Chart V.0.5 **Assumption for euro area inflation**
(y-o-y growth, in %)

Sources: Consensus Forecast and NBS estimate.

³⁰ The assumption for the euro area's GDP growth in 2016 and 2017 is consistent with the January Consensus Forecast.

³¹ Measured by the composite index which comprises dollar prices of wheat, corn and soybean on benchmark commodity markets.

³² Brent.

prices hit their 13-year low (around USD 27 per barrel) in January, but then regained some ground, settling below USD 35 per barrel in early February. Consistent with this, the assumption for oil prices has been revised down relative to the November projection. Taking into account the movement in oil futures, we expect oil prices to go up close to USD 40 per barrel until the end of 2016 and to around USD 45 per barrel until the end of 2017.

Internal assumptions

In view of the outlook for international prices of primary agricultural commodities and the influence they have on their counterparts in Serbia, we have assumed that domestic primary agricultural commodity prices will record moderate growth both this and the next year.

Administered price growth should come at around 4.0% in 2016. This growth is lower than assumed in the November projection because cigarette prices were raised as early as in December (ahead of the anticipated increase of the excise tax in January 2016). Hence, the overall administered price growth in 2015 turned out somewhat higher (5.5%), while in 2016 it is likely to be lower than projected earlier. Just like the year before, the strongest impetus to administered price growth in 2016 should come from prices of electricity (assumed to go up by 7%) and cigarettes.

In accordance with the *Fiscal Strategy for 2016 with Projections for 2017 and 2018*, we have assumed further consistent implementation of fiscal consolidation that will ensure sustainable public finance and put public debt on a downward path from 2017 onwards. In line with this, the country risk premium should also be stable. Continued narrowing of the current account deficit in 2016 and an inflow of FDIs in excess of the deficit financing needs are expected to further underpin the stability of the foreign exchange market.

The projection operates on the assumption of an appreciation trend of the real exchange rate, which is typical for transition economies and conditioned by the removal of price disparities, notably in terms of administered prices, and by the Balassa-Samuelson effect³³.

Chart V.0.6 Assumption for international prices of primary agricultural commodities
(Q4 2013 = 100)

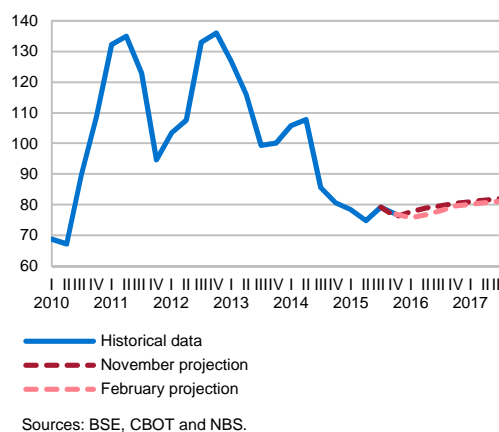
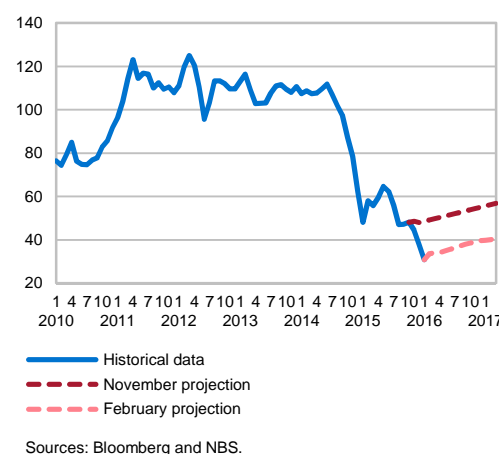


Chart V.0.7 Assumption for Brent oil prices
(USD/barrel)



³³ In transition economies, the process of convergence towards income levels in advanced economies is accompanied by the relatively faster growth in prices (price convergence).

Projection

Inflation projection

Weighed down by the continued fall in primary commodity prices, y-o-y inflation will stay rather low over the next several months. It is however expected to start rising in H2 and to return within the target band late this or early next year. In 2017, inflation is projected to move around 3.0%.

Short-term inflation projection

Under the short-term inflation projection, y-o-y inflation will continue below the lower bound of the target tolerance band in Q1. Despite some increase in January on account of the base effect, inflation will be on a decline in the two months that follow.

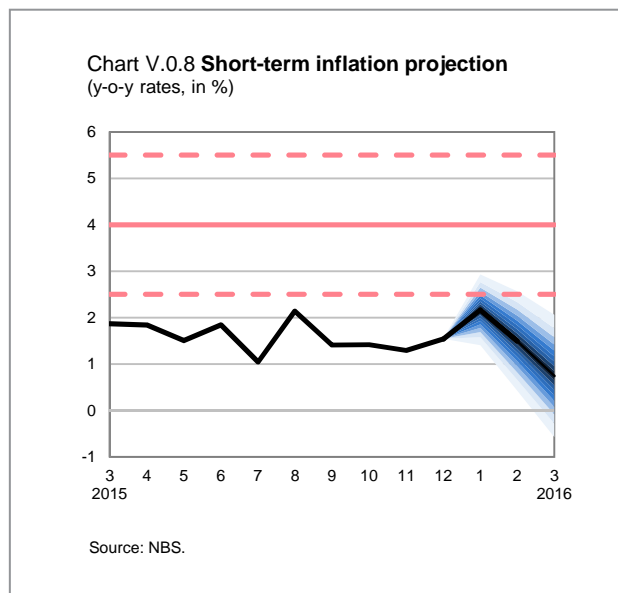
At quarterly level, Q1 inflation will be led by the seasonal increase in fruit and vegetable prices, while a dampening effect will originate from the fall in petroleum product prices, given the persistent decline in international crude oil prices.

Core inflation (CPI excluding food, energy, alcohol and cigarettes) should also continue moving below the lower bound of the target tolerance band in Q1. At quarterly level, core inflation will probably stagnate as the seasonally-induced fall in prices of travel packages, clothing and footwear may be offset by the rise in prices of other non-food products and services.

Medium-term inflation projection

Having been on a downward path for an extended period of time, y-o-y inflation is projected to rise moderately from mid-2016 and make its way back within the target band late this or early next year. We estimate that its growth will continue in 2017, though at a much slower rate, averaging around 3.0%. The gradual increase in inflation over the projection horizon will be driven most by the weakening of disinflationary pressures amid expected rise in international primary commodity prices, aggregate demand in Serbia and inflation abroad.

Y-o-y inflation will remain subdued in H1, due mainly to the decline in international prices of primary commodities



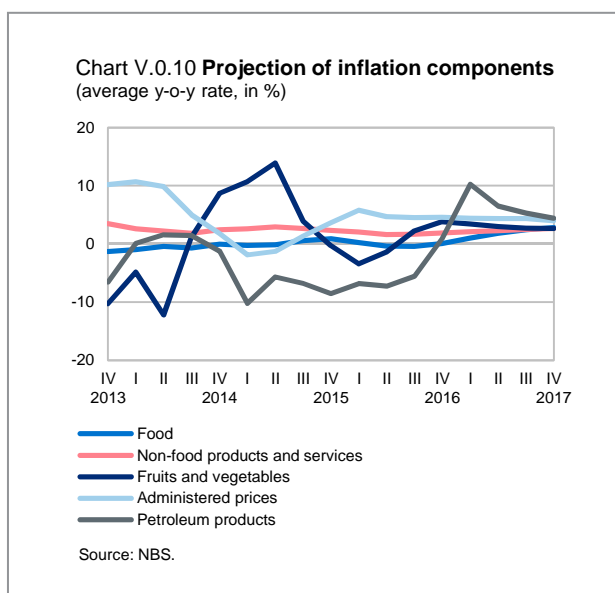
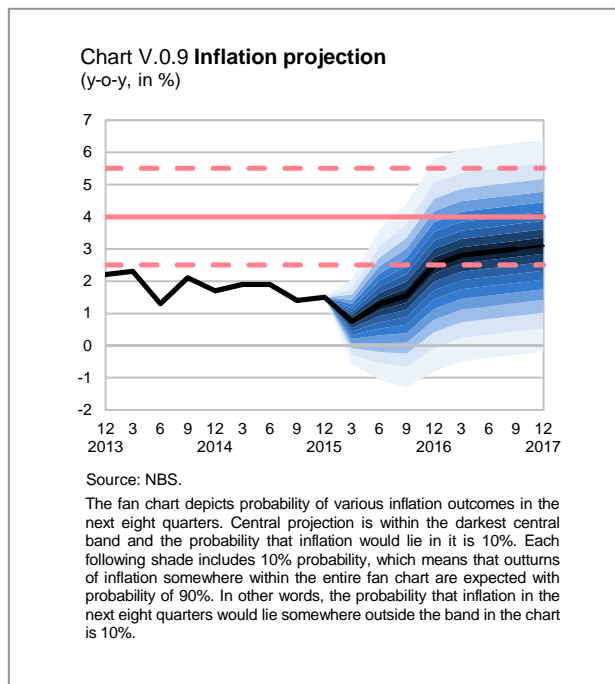
(notably oil) over the past several months. However, the disinflationary effects on this account are, as a rule, only short-lived and will start fading out in H2.

The assumed increase in international oil prices over the projection horizon, coupled with the low base, should lead to the gradual waning of the disinflationary effect of domestic petroleum product prices. According to our estimates, this will happen from mid-year onwards, which means that the negative contribution of petroleum product prices to inflation will diminish and probably turn positive late this or early next year. However, given the around 5% share of petroleum products in the consumer basket and the relatively low oil prices expected next year as well, the contribution of petroleum product prices to inflation should not go above 0.35 pp on average.

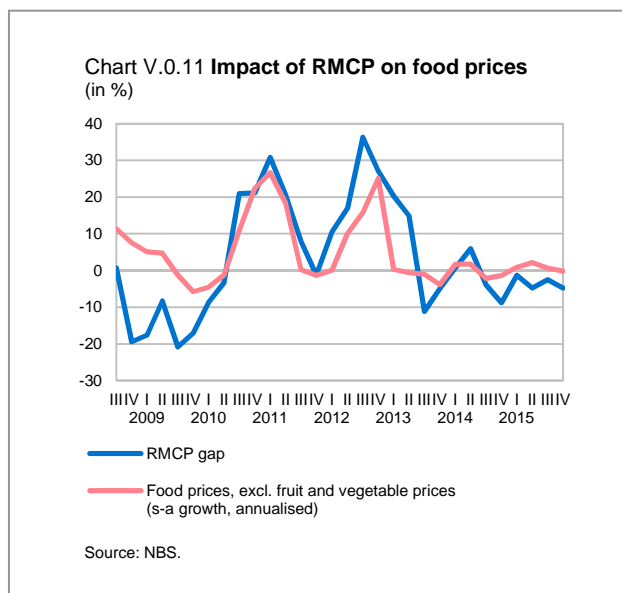
Food inflation has been lingering around zero for more than two years now, as a result of low prices of primary agricultural commodities in the international and domestic markets, i.e. low food production input costs (negative RMCP gap³⁴). Since primary agricultural commodity prices are likely to stay low over the projection horizon, i.e. to rise only moderately, the y-o-y growth in food inflation is not likely before the start of the next year. However, even at the end of the forecast period, this growth should remain under 3.0%. Fruit and vegetable prices are currently below their “neutral” level (i.e. long-term trend), mainly because of a very good last year’s season for the majority of key fruit and vegetable cultures. Hence, assuming an average season this year, these prices can reasonably be expected to increase, though not more than 4.0% y-o-y according to our estimate.

In line with the above assumptions, y-o-y administered price growth will measure 4–5% both this and the next year and will be led mainly by the assumed increase in electricity and cigarette prices. Hence, administered prices will provide the largest positive contribution to inflation over the forecast period (0.8–1.0 pp).

Owing to relatively stable RSD/EUR exchange rate movements for the major part of 2015 and muted inflationary pressures in the international environment, y-o-y growth in prices of non-food products and services has been weak for quite some time already (below 3%) and should remain so over the projection horizon.



³⁴ Real marginal costs of processed food producers (RMCP) are calculated as the ratio of primary agricultural commodity prices and food prices. Negative RMCP gap opens when these costs fall below the trend level.



However, we expect that the y-o-y growth in those prices will be slightly faster in 2017 than in 2016 due to the open depreciation gap of the real exchange rate and the anticipated rise in the euro area inflation (given the ECB's accommodative monetary policy stance).

The disinflationary effect of aggregate demand should grow weaker. Though the negative output gap opened back in 2008 following the spill-over of the global financial crisis to Serbia, its narrowing over the past year has been noticeable. We expect that trend to continue, given the monetary policy easing by the NBS and the accommodative stance of the ECB, which should serve as a catalyst to the recovery of economic activity in Serbia and the euro area, respectively. Also, after falling in the last four years, initially due to the crisis and subsequently on account of fiscal consolidation, we expect that household consumption will start healing this year.

Table V.0.2 Projections of key macroeconomic indicators for Serbia

	2016		2017	
	Previous	New	Previous	New
Inflation (annual average, in %)				
IMF	3.4	2.8	4.0	3.9
European Commission	3.3	2.4	4.0	3.6
Consensus Forecast	3.5	2.6	-	3.5
Bloomberg	3.2	2.9	3.5	3.7
GDP (%)				
IMF	1.5	1.8	2.0	2.2
European Commission	1.4	1.6	2.5	2.5
Consensus Forecast	1.6	1.7	-	2.4
Bloomberg	1.6	1.7	2.3	2.2
Current account deficit (% of GDP)				
IMF	3.8	4.6	3.9	4.3
European Commission	4.5	4.9	4.5	4.9
Consensus Forecast*	4.5	4.8	-	4.2
Bloomberg	4.2	4.6	3.7	4.4
Fiscal deficit (% of GDP)				
IMF	3.9	4.0	3.0	2.6
European Commission	4.1	3.7	3.8	3.5
Consensus Forecast	-	-	-	-
Bloomberg	3.8	4.0	3.5	3.1

Sources: IMF (Republic of Serbia: Second Review under the Stand-By Arrangement, Country Report No. 15/296 and Republic of Serbia: Third Review under the Stand-By Arrangement, Country Report No. 15/347), European Commission (Autumn forecast 2015 and Winter forecast 2016) and Consensus Forecast (October 2015 and January 2016) and Bloomberg Quarterly Survey (October 2015 and January 2016).

* Calculated based on the NBS projection of dollar GDP in October 2015 and January 2016.

The latest available expectations of other relevant institutions regarding inflation in Serbia are slightly higher than our expectations, but still relatively low (below 3.0% in 2016 and below 4.0% in 2017), while their forecasts of economic activity are similar to our projection presented in this *Report*. Besides, selected institutions expect the current account deficit to stand at 4–5% of GDP both this and the next year and the budget deficit to decrease further from 2017 onwards.

The risks to the projected inflation path are associated primarily with future developments in the international commodity and financial markets, and to a certain degree, with the pace of economic recovery of the euro area.³⁵

Based on information from the futures markets, we have assumed that over the forecast period the prices of primary commodities (oil and primary agricultural commodities) will record a mild rise from their current low levels. However, as primary commodity prices are generally volatile and susceptible to numerous factors, the likelihood that they will deviate from the assumed path is not at all negligible. Oil prices, for instance, are more likely to go up than to go down in the medium run. More precisely, there has been a considerable cutback in investment in oil industry since late 2014, which means that future demand increases could be unmet and thus exert upward pressure on oil prices which recently hit their 13-year nadir. On the other hand, assuming geopolitical tensions in the Middle East do not cause any

³⁵ For more information about the risks, see Text box 5, p. 49.

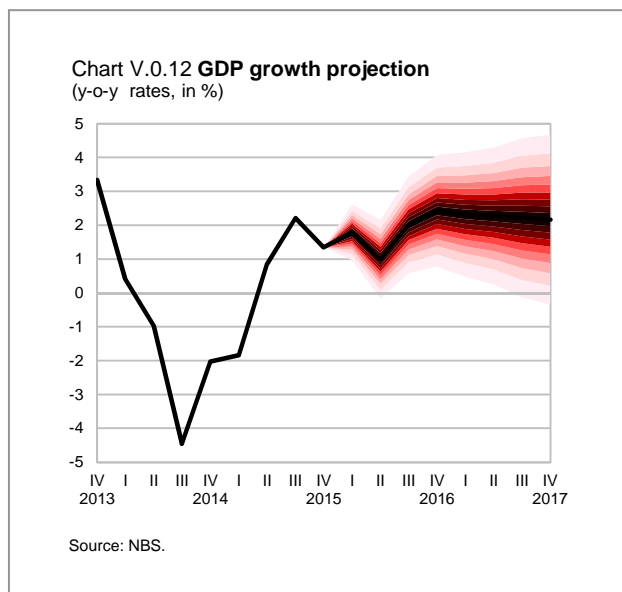
supply disruptions, in the near term downside risks to oil prices will probably persist because of the currently high oil inventories, sluggish global recovery, the possibility of Iran's faster return to the market than expected, and a potential increase in competition among OPEC members. To sum up, even though we have assumed a mild recovery in oil prices over the projection horizon, it is not at all impossible that this recovery will not take place. Lower oil prices normally feed through into lower cereal prices (corn, wheat, soybean), since they reduce the costs of fertiliser production and transport and discourage production of biofuels from cereals. Also, piling up of cereal inventories in the last two years could heap pressure on cereal prices over the short run. All of this taken into account, the risks to the projected path of primary commodity prices in the short run are judged to be tilted to the downside.

Downside risk is also embodied in the possibly slower than expected recovery of the euro area, despite the ECB's monetary accommodation. The potential reasons lie in the slowing growth of emerging markets, notably China, which could dampen the demand for euro area's exports, and in the ongoing geopolitical tensions. Should this downside risk materialise, we are likely to see a larger negative output gap and slower weakening of disinflationary pressures from aggregate demand.

On the other hand, upside risks to the projected inflation path relate primarily to developments in the international financial market which continues to see heightened volatility and increased investor risk aversion, probably as a consequence of the Fed's rate hike and turmoil in China's financial market. Continuation of these movements could dampen capital inflows to emerging markets, Serbia included, and trigger depreciation pressures, potentially feeding into higher domestic prices.

On balance, the risks to inflation projection are judged to be symmetric.

As inflationary pressures are likely to stay low in the period ahead, the monetary policy stance of the NBS should remain expansionary. Given the current prevalence of external risks associated with movements in the international financial and commodity markets, the degree of monetary expansion will depend primarily on the assessment of their potential inflationary effect.



GDP projection

The recovery of economic activity is expected to step up on the back of stronger domestic demand. Following 0.8% in 2015, GDP growth is projected to accelerate to 1.8% in 2016 and to 2.2% in 2017.

As in the previous year, growth in 2016 should be led by investment, while net exports will most probably provide a neutral contribution. However, by contrast to 2015, when household consumption acted as a drag on GDP growth due to fiscal consolidation, this year we expect it to become a positive contributor.

Investment is expected to increase as a result of several factors: past and future structural reforms, lower oil prices which reduce operating costs for businesses, more favourable terms of borrowing, increase in government capital expenditure, expected further recovery of the euro area economy and continuing stable inflow of FDI. However, while the healing of external demand benefits our exports, the increase in investment inevitably leads to higher imports since, technology-wise, our economy is import-dependent. We therefore estimate that this year again the contribution of net exports will be neutral. In addition to higher investment and exports, which should support the real growth in private sector wages, the increase in household consumption will be aided by lower oil prices which have a positive effect on the disposable income of households. Consumption may also be boosted by severance payments in the context of public sector rightsizing.

On the production side, higher investment should have a positive impact, chiefly on industry and construction. Within industry, the contribution to GDP growth will be evenly distributed between manufacturing and the sectors of energy and mining that will continue to record high y-o-y growth rates in H1 thanks to the low last year's base.³⁶ Positive contribution to GDP is expected also from agricultural production (around 4% growth), where following below-average performance last year, we assume average performance this year.

Favourable trends in 2016 should continue in 2017, i.e. economic growth should continue to be driven by investment, with an increasing contribution of household consumption. Stronger domestic demand should lead to import growth, for which reason the contribution of net exports to GDP will stay close to neutral despite the

³⁶ Energy and mining recovered from the significant 2014 flood damage to their capacities and achieved pre-flood levels of activity around mid-2015.

expected rise in exports. On the other hand, as fiscal consolidation is expected to proceed, government consumption will record a decline in 2017 and provide a negative contribution to GDP.

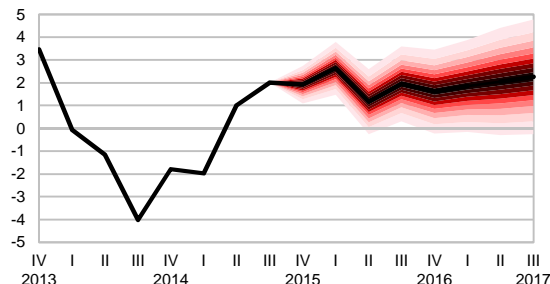
The risks to GDP projection are associated mainly with the speed of economic recovery of the euro area, movements in international primary commodity prices and further pace of structural reforms at home.

Even though the sustained low level of oil prices and the unconventional ECB measures could lead to its acceleration, the recovery of the euro area could be slowed down if the slackening growth of emerging markets, notably China, weighs down, through reduced import demand, on euro area exports. Headwinds to the recovery of the euro area could also come from the ongoing geopolitical tensions. The euro area being our main trade partner, Serbia would probably see a slowdown in investment and exports, and consequently, in GDP. Downside risks are also associated with international prices of primary commodities, notably primary agricultural commodities and base metals of which Serbia is a net exporter. On the other hand, the sustained low level of oil prices could serve as a fillip to GDP growth, through higher disposable household income, i.e. possibly higher consumption, as well as through lower cost for businesses.

As regards internal factors, further consistent implementation of structural reforms and improvement in the investment and business environment should have a positive effect on GDP in the medium term. Moreover, the expected increase in public sector efficiency and the reform of state-owned enterprises could also contribute to a faster than expected economic growth. On balance, the risks to GDP projection are judged to be symmetric.

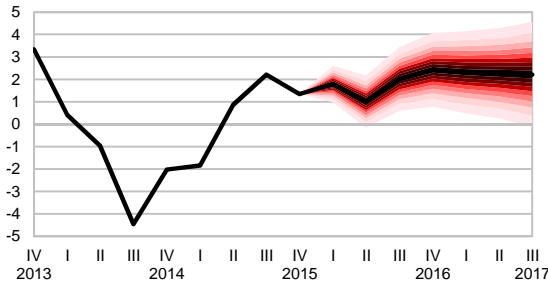
Chart V.0.13 Current vs. previous GDP growth projection

November projection
(y-o-y rates, in %)



Source: NBS.

February projection
(y-o-y rates, in %)



Comparison and outcome of inflation projections

Our new inflation projection is lower than the one published in the November Report and the possible outcomes for inflation are symmetrically dispersed around the central projection rate since downside and upside risks in the coming period appear to be balanced. The projected lower inflation is attributable primarily to renewed fall in global oil prices and the downward revision to their assumed growth during the forecast period. More precisely, in conditions of a swelling oil glut, oil prices lost more than 40%, tumbling down from over USD 50 per barrel in early October to less than USD 30 per barrel in January. As a result, we do not expect these prices to exceed USD 45 per barrel until the end of 2017, while previously we anticipated they could reach close to USD 60 per barrel. Another indication of stronger disinflationary pressures relative to the November projection is the renewed fall in prices of primary agricultural commodities and the expectation of their somewhat weaker growth in the period ahead, as well as lower euro area inflation forecast (average inflation in 2016 was adjusted from 1.1% to 0.8%). Administered price growth in 2016 has also been revised down.

During the last year, y-o-y inflation was moving within the projection range published in the February 2015 *Inflation Report*, slipping however considerably below the central projection rate in the last two quarters. Inflation deviated south of the central projection rate because primary commodity prices (oil and primary agricultural commodities) turned out to be much lower than assumed a year ago and because administered prices increased less than anticipated for 2015.

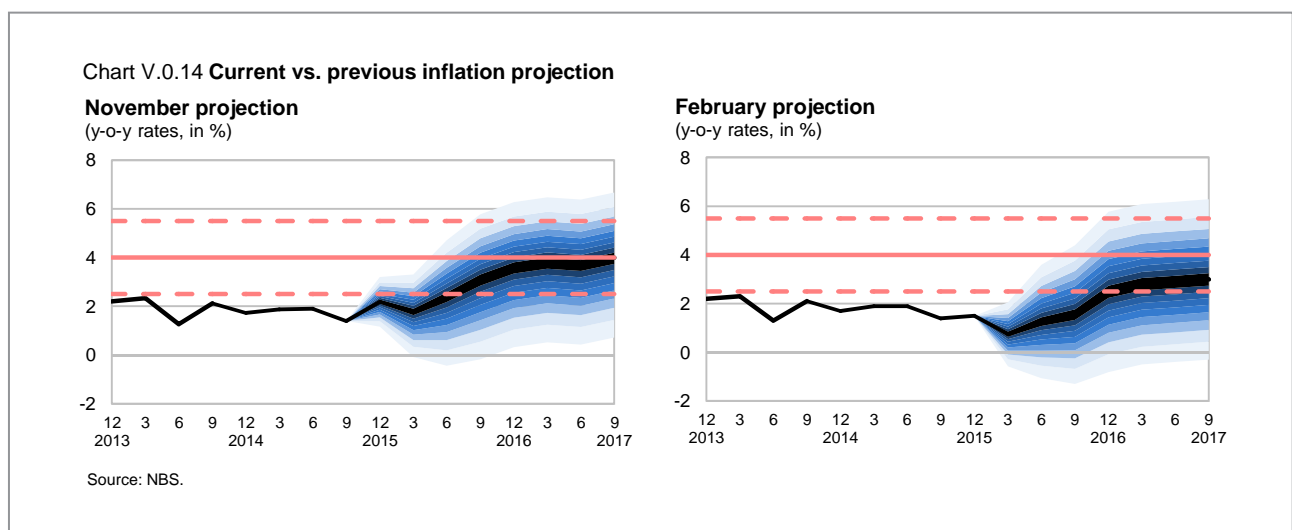
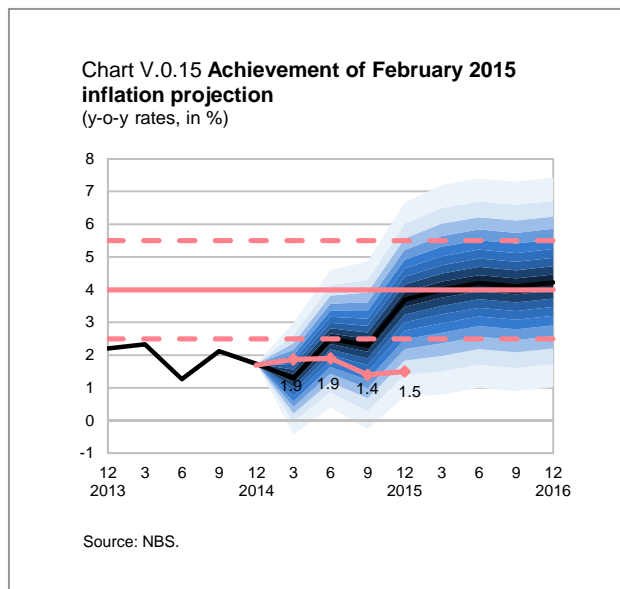


Table A
Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Q1 2015	Q2 2015	Q3 2015	Q4 2015	2015
EXTERNAL LIQUIDITY INDICATORS (in %)															
FX reserves/imports of goods and services (in months)	6.1	9.0	7.5	5.4	9.7	8.4	8.8	7.7	7.6	6.6	6.9	6.6	6.8	6.6 ²⁾	6.6 ²⁾
FX reserves/short-term debt	177.0	265.1	250.6	162.6	220.6	191.2	299.8	240.2	269.7	316.3	339.5	325.6	335.5	303.4 ²⁾	303.4 ²⁾
FX reserves /GDP	23.3	36.9	32.7	24.2	34.6	33.6	36.1	34.5	32.7	29.7	32.0	31.5	32.1	31.4	31.4
Debt repayment/GDP	5.0	10.3	10.3	10.7	12.8	12.0	12.4	13.0	13.2	14.1	12.3	10.6	11.5	11.6 ²⁾	11.5 ²⁾
Debt repayment/exports of goods and services	19.8	36.2	37.5	37.5	48.8	37.5	37.3	36.0	32.6	32.6	25.1	21.7	24.5	25.8 ²⁾	24.3 ²⁾
EXTERNAL SOLVENCY INDICATORS (in %)															
External debt/GDP	59.3	58.5	59.0	62.3	72.7	79.0	72.2	80.9	75.1	77.3	81.2	81.1	80.2	80.3 ²⁾	80.3 ²⁾
Short-term debt/GDP	13.2	13.9	13.1	14.9	15.7	17.6	12.0	14.3	12.1	9.4	9.4	9.7	9.6	10.4 ²⁾	10.4 ²⁾
External debt/exports of goods and services	234.9	205.7	214.3	218.9	276.9	247.1	216.5	223.6	184.7	178.1	181.9	176.5	171.3	169.8 ²⁾	169.8 ²⁾
FINANCIAL RISK EXPOSURE INDICATORS (in %)															
FX reserves/M1	290.3	356.1	306.7	300.4	393.4	416.6	429.6	402.1	330.4	278.1	318.8	292.0	277.4	250.2	250.2
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	199.9	196.6	201.9	193.6	204.3	193.7	193.7
OPENNESS OF ECONOMY (EXPORTS+IMPORTS)/GDP															
	70.8	77.4	80.1	82.6	69.0	79.8	82.7	89.8	92.6	97.7	110.1	106.9	102.1	100.0 ²⁾	104.5 ²⁾
MEMORANDUM: (in EUR million)															
GDP ¹⁾	21103	24435	29452	33705	30655	29766	33424	31683	34263	33319	7234	8178	8595	9030 ²⁾	33034 ²⁾
External debt	12520	14291	17382	20982	22272	23509	24123	25645	25738	25741	26689	26494	26292	26513 ²⁾	26513 ²⁾
External debt servicing	1054	2513	3039	3594	3922	3564	4154	4130	4539	4711	887	867	992	1044 ²⁾	3790 ²⁾
Central bank foreign exchange reserves	4922	9020	9634	8162	10602	10002	12058	10915	11189	9907	10515	10293	10511	10378	10378
Short-term debt ³⁾	951	968	1044	1832	1843	1752	601	455	196	102	164	185	220	30 ²⁾	30 ²⁾
Current account balance	-1778	-2356	-5474	-7126	-2032	-2037	-3656	-3671	-2098	-1985	-511	-284	-345	-45 ²⁾	-1590 ²⁾

CREDIT RATING (change of rating and outlook)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
	July/May	Feb	July	March/Dec	Dec	Nov	March	Aug	July	Jan	Dec	Jan
S&P	BB- /stable	BB- /positive	BB- /stable	BB- /negative	BB- /stable		BB /stable	BB- /negative				BB- /stable
Fitch	BB- /stable			BB- /negative		BB- /stable		BB- /negative		B+ /stable	B+ /positive	
Moody's									B1 /stable			

Methodological notes:

Foreign exchange reserves/imports of goods and services (in months) - ratio of end-of-period foreign exchange reserves to average monthly imports of goods and services during period under review.

Foreign exchange reserves/short-term debt (in %) - ratio of foreign exchange reserves to stock of short-term debt at remaining maturity at end-of-period.

Foreign exchange reserves/GDP (in %) - ratio of end-of-period foreign exchange reserves to GDP.

Debt repayment/GDP (in %) - ratio of debt repayment (excl. early repayment of a part of debt to London Club creditors) to GDP during period under review.

Debt repayment/exports (in %) - ratio of debt repayment (excl. early repayment of a part of debt to London Club creditors) to exports of goods and services during period under review.

External debt/GDP - ratio of end-of-period outstanding debt to GDP.

Short-term debt/GDP - ratio of end-of-period short-term debt at remaining maturity to GDP.

External debt/exports (in %) - ratio of end-of-period outstanding debt to annual value of exports of goods and services.

Foreign exchange reserves/M1 (in %) - ratio of foreign exchange reserves to money supply at end-of-period.

(Exports + imports)/GDP (in %) - ratio of value of exports and imports of goods and services to GDP during period under review.

¹⁾ According to ESA 2010.

²⁾ NBS estimate.

³⁾ At original maturity.

Notes:

1. Data are subject to corrections in line with the official data sources.

2. Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM 6. Data for 2005 and 2006 are shown according to BPM 5.

3. As of 1 January 2010 the Serbian Statistical Office applies the general trade system of registration of exports and imports which is a broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using the special trade system. Trade with Montenegro is registered within relevant transactions as of 2003.

4. In September 2010, the methodology of external debt statistics was changed – public sector external debt now includes liabilities under SDR allocation (EUR 492.6 mln) used in December 2009. Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 996.2 mln, of which EUR 431.1 mln relates to domestic banks and EUR 565.1 mln to domestic enterprises).

5. Foreign debt repayment does not include: short-term debt repayment and advance debt repayment.

Table B
Key macroeconomic indicators

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Q1 2015	Q2 2015	Q3 2015	Q4 2015	2015
Real GDP growth (in %) ¹⁾	5.5	4.9	5.9	5.4	-3.1	0.6	14	-10	2.6	-18	-18	0.9	2.2	1.3	0.8
Consumer prices (in % relative to the same month a year earlier) ²⁾	17.7	6.6	11.0	8.6	6.6	10.3	7.0	12.2	2.2	17	19	19	14	15	15
NBS foreign exchange reserves (in EUR million)	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	9,907	10,515	10,293	10,511	10,378	10,378
Exports (in EUR million) ³⁾	5,329	6,948	8,110	9,583	8,043	9,515	11,145	11,469	13,937	14,451	3,528	3,992	4,046	4,052 ⁴⁾	15,618 ⁵⁾
- growth rate in % compared to a year earlier	19.1	30.4	-	18.2	-16.1	18.3	17.1	2.9	215	3.7	6.8	9.2	9.1	7.1 ⁶⁾	8.1 ⁶⁾
Imports (in EUR million) ³⁾	9,612	11,970	15,468	18,267	13,099	14,244	16,487	16,992	17,782	18,096	4,438	4,754	4,728	4,978 ⁶⁾	18,899 ⁶⁾
- growth rate in % compared to a year earlier	0.7	24.5	-	18.1	-28.3	8.7	15.7	3.1	4.7	18	7.2	3.9	19	5.0 ⁶⁾	4.4 ⁶⁾
Current account balance ³⁾ (in EUR million)	-1,778	-2,356	-5,474	-7,126	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-511	-284	-345	-451 ⁶⁾	-1,590 ⁶⁾
as % of GDP	-8.4	-9.6	-18.6	-21.1	-6.6	-6.8	-10.9	-11.6	-6.1	-6.0	-7.1	-3.5	-4.0	-5.0 ⁶⁾	-4.8 ⁶⁾
Unemployment according to the Survey (in %)	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	19.4 ⁷⁾	19.2	17.9	16.7		
Wages (average for the period, in EUR)	209.7	260.0	347.1	400.5	337.4	330.1	372.5	364.5	388.6	379.3	344.0	371.3	372.5	384.3	368.0
RS budget deficit/surplus (in % of GDP) ⁴⁾	0.5	-1.7	-1.6	-1.7	-3.2	-3.4	-4.0	-5.9	-5.2	-6.3	-2.4	-0.5	-0.8	-7.3	-2.9
Consolidated fiscal result (in % of GDP) ⁴⁾	1.2	-1.5	-1.9	-2.6	-4.4	-4.6	-4.8	-6.8	-5.5	-6.6	-2.4	-1.4	-1.5	-8.9	-3.7
RS public debt, (central government, in % of GDP)	50.2	35.9	29.9	28.3	32.8	41.8	45.4	56.2	59.6	70.4	74.6	73.2	72.9	75.6	75.6
RSD/USD exchange rate (period average)	66.87	67.03	58.39	55.76	67.47	77.91	73.34	88.12	85.17	88.54	108.15	108.86	108.06	110.30	108.85
RSD/USD exchange rate (end of period)	72.22	59.98	53.73	62.90	66.73	79.28	80.87	86.18	83.13	99.46	111.42	107.73	106.49	111.25	111.25
RSD/EUR exchange rate (period average)	82.99	84.11	79.96	81.44	93.95	103.04	101.95	113.13	113.14	117.31	121.50	120.44	120.21	120.85	120.73
RSD/EUR exchange rate (end of period)	85.50	79.00	79.24	88.60	95.89	105.50	104.64	113.72	114.64	120.96	120.22	120.60	119.75	121.63	121.63
MEMORANDUM:															
GDP (in EUR million) ⁵⁾	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,319	7,234	8,178	8,595	9,030 ⁶⁾	33,034 ⁶⁾

¹⁾ At constant prices of previous year.

²⁾ Retail prices until 2006.

³⁾ Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM 6. Data for 2005 and 2006 are shown according to BPM 5. Due to the break in the series for 2007, exports and imports growth rates are not shown. As of 1 January 2010, the Serbian Statistical Office applies the general trade system of registration of exports and imports which is a broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. The Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using the special trade system. Trade with Montenegro is registered within relevant transactions as of 2003.

⁴⁾ Includes below-the-line items (payment of called guarantees, bank recapitalisations and debt takeover) in line with IMF methodology, as of 2008 on RS budget level and as of 2005 on consolidated level.

⁵⁾ According to ESA 2010.

⁶⁾ NBS estimate.

⁷⁾ Revised data for 2014 according to the new methodology of Labour Force Survey.

Notes:

1. Data are subject to corrections in line with official data sources.

2. Source for the data on unemployment: Labour Force Survey, Statistical Office.

3. Source: MoF for public debt and NBS for estimated GDP.

Index of charts and tables

Charts

III.0.1	Price movements	8
III.0.2	Contribution to y-o-y consumer price growth	8
III.0.3	Contribution to quarterly consumer price growth	8
III.0.4	Contribution to quarterly producer price growth	9
III.0.5	Domestic inflation and external prices	10
III.0.6	Current inflation and one-year ahead inflation expectations	13
III.0.7	Two-year ahead inflation expectations	13
III.0.8	Targeted inflation and one-year ahead inflation expectations – financial sector	13
III.0.9	Expectations of enterprises regarding a change in prices of their inputs, products and services	14
IV.1.1	Dinar liquidity	17
IV.1.2	Interest rate movements	18
IV.1.3	Yield curve in the interbank money market	18
IV.1.4	Primary market of government dinar securities – performance ratio and foreign investor participation	18
IV.1.5	Interest rates in the primary market of government securities	19
IV.1.6	Interest rates on new dinar loans and new corporate and household deposits	19
IV.1.7	Interest rates on FX loans and corporate and household deposits	19
IV.1.8	Risk premium indicator – EMBI by country	21
IV.1.9	Yields on eurobonds of countries in the region	21
IV.1.10	Current account deficit and net capital inflow	22
IV.1.11	Structure of the financial account	22
IV.1.12	Financial loans of residents – change in net borrowing	22
IV.1.13	Movements in RSD/USD and EUR/USD exchange rates	23
IV.1.14	Movements in EUR/RSD exchange rate and NBS FX interventions	23
IV.1.15	Short-term volatility of the RSD/EUR exchange rate	24
IV.1.16	Movements in exchange rates of national currencies against the euro	24
IV.1.17	BELEX15 and Belgrade Stock Exchange turnover	25
IV.1.18	Stock exchange indices across the region	25
IV.2.1	Monetary aggregates and CPI	26
IV.2.2	Contribution to y-o-y growth in M2, by sector	26
IV.2.3	Contribution to M3 growth	27
IV.2.4	Lending activity and GDP	27
IV.2.5	Structure of new corporate loans	28
IV.2.6	Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to enterprises	28
IV.2.7	Structure of new household loans	29
IV.2.8	Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to households	29
IV.2.9	Share of dinar in total bank receivables from corporate and household sectors	29
IV.2.10	NPL share in total loans, gross principle	30
IV.3.1.	<i>DOMex</i> and real estate transactions	30
IV.3.2.	Indices of the number of issued construction permits	30
IV.4.1.	Contributions to y-o-y GDP growth rate – expenditure side	31
IV.4.2.	Household consumption	31
IV.4.3	Government consumption	31
IV.4.4	Exports and imports of goods and services	32
IV.4.5	Movements in external demand and core exports indicators	33
IV.4.6	Exports of services	33
IV.4.7	Imports by key components	33
IV.4.8	Energy imports	34
IV.4.9	Commodity trade in euros	34

IV.5.1	Economic activity indicators	37
IV.5.2	Volume of production by branches of manufacturing	38
IV.5.3	Volume of production in energy and mining	38
IV.5.4	Contributions to y-o-y growth of the volume of industrial production	38
IV.6.1	Real net wages	39
IV.6.2	Ratio of average nominal net wage in public and non-public sector	39
IV.6.3	Real net wage movements	39
IV.6.4	Movements in productivity, real gross wages and unit labour costs in industry	40
IV.6.5	Labour market indicators under the Labour Force Survey	40
IV.7.1	Movements in GDP and economic activity indicators of the euro area	42
IV.7.2	PMI Manufacturing for selected countries	43
IV.7.3	Revisions of real GDP growth forecasts for 2015 and 2016 by the IMF	43
IV.7.4	Leading economic indicators in the US	43
IV.7.5	US labour market	44
IV.7.6	HICP across selected countries	45
IV.7.7	Long-term inflation expectations in the euro area	46
IV.7.8	Policy rates across selected countries	46
IV.7.9	Yield on 10-year bonds of selected countries	46
IV.7.10	Implied volatility of the global financial market	47
IV.7.11	Exchange rates of selected national currencies against the dollar	47
IV.7.12	Oil and copper price movements	47
IV.7.13	World food price index	48
V.0.1	Monetary conditions index	52
V.0.2	Real interest rate	52
V.0.3	Fiscal trends	53
V.0.4	Output gap	53
V.0.5	Assumption for euro area inflation	54
V.0.6	Assumption for international prices of primary agricultural commodities	55
V.0.7	Assumption for Brent oil prices	55
V.0.8	Short-term inflation projection	56
V.0.9	Inflation projection	57
V.0.10	Projection of inflation components	57
V.0.11	Impact of RMCP on food prices	58
V.0.12	GDP growth projection	60
V.0.13	Current vs. previous GDP growth projection	61
V.0.14	Current vs. previous inflation projection	62
V.0.15	Achievement of February 2015 inflation projection	62

Tables

III.0.1	Consumer price growth by component	7
III.0.2	Price growth indicators	9
IV.2.1	Monetary aggregates	26
IV.4.1	Investment indicators	32
IV.5.1	Annual GDP growth and contributions	37
IV.6.1	Movements in formal employment and unemployment	41
IV.7.1	Economic growth estimate by country	44
V.0.1	Projection assumptions	54
V.0.2	Projections of key macroeconomic indicators for Serbia	58
Table A	Indicators of Serbia's external position	63
Table B	Key macroeconomic indicators	64

Charts in text boxes

O.1.1	Number of European countries with inflation running below the target, of total 36 inflation-targeters	11
O.1.2	Inflation and the target by country in December 2015	11
O.2.1	Perceived and expected inflation of households	16
O.3.1	Movements in interest rates on household and corporate loans – new business and outstanding amounts	20
O.4.1	New investment loans and FDI	36

Table in text box

O.4.1	Investment indicators in 2015	35
-------	-------------------------------	----

Executive Board meetings and changes in the key policy rate

2015

Date	Key policy rate (p.a, in %)	Change (in basis points)
15 January	8.00	0
12 February	8.00	0
12 March	7.50	-50
9 April	7.00	-50
11 May	6.50	-50
11 June	6.00	-50
9 July	6.00	0
13 August	5.50	-50
10 September	5.00	-50
15 October	4.50	-50
12 November	4.50	0
10 December	4.50	0

2016

Date	Key policy rate (p.a, in %)	Change (in basis points)
12 January	4.50	0
11 February	4.25	-25
17 March		
7 April		
17 May		
9 June		
7 July		
11 August		
8 September		
13 October		
10 November		
8 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 10 December 2015

At its meeting today, the NBS Executive Board decided to keep the key policy rate unchanged at 4.5%.

The decision was made in consideration of the prevailing uncertainties associated primarily with the international environment. Above all, the response of market participants to the expected increase in the Fed's rate is uncertain, including the effects of such increase on commodity and financial markets, notably capital flows towards emerging economies. Even so, these effects will be mitigated by the ECB's further monetary accommodation in December and the extension of quantitative easing until March 2017.

The NBS Executive Board also considered how seasonal factors may affect liquidity movements primarily with regard to energy imports during winter months and the dynamics of fiscal expenditure execution. However, progress in fiscal consolidation and narrowing of external imbalances, coupled with favourable external funding conditions, will contribute to the relative stability of the dinar in the medium run. Based on our estimate, this year's fiscal deficit will be lower by around 40% relative to 2014. The current account deficit will be down by about one-fourth compared to last year and will be fully covered by FDI. The anticipated gradual narrowing of internal and external imbalances will boost Serbia's resilience to shocks in the international environment in the years to come.

The Executive Board stated that inflationary pressures will remain subdued in the coming period due both to domestic and global factors. At 1.4% in October, year-on-year inflation is below the NBS target tolerance band, with inflation expectations of the financial and corporate sectors also trending below the 4.0% inflation target for one and two years ahead. Inflation is expected to return within the target tolerance band in the second half of 2016.

Given the risks associated with developments in the international commodity and financial markets, the degree of expansiveness of the NBS monetary policy in the period ahead will depend primarily on the assessment of their potential effect on inflation.

The next rate-setting meeting of the Executive Board will be held on 12 January 2016.

Press release from Executive Board meeting held on 12 January 2016

At its meeting today, the NBS Executive Board decided to keep the key policy rate unchanged at 4.5%.

The decision was made in consideration of the prevailing uncertainties in the international environment. With the start of normalization of the Fed's monetary policy, uncertainties are now mostly associated with the pace and scale of policy rate increases during 2016, which will have a major impact on commodity and financial markets and capital flows towards emerging economies. Even so, these effects will be moderated by the ECB's further monetary easing begun last December and the extension of non-standard measures until March 2017. Against a backdrop of strong geopolitical tensions, uncertainties in the international environment are further accentuated by turbulences in the financial market and Chinese growth slowdown.

However, progress in fiscal consolidation, sustainability of public finances, improvement in the business and investment environment and the narrowing of external imbalances have greatly contributed to increasing domestic economy's resilience to risks in the international environment.

The Executive Board assessed that inflationary pressures will remain subdued in the period ahead. Y-o-y inflation is below the NBS target. Both one- and two-year ahead inflation expectations of financial and corporate sectors are still below the midpoint of 4%. Low prices of primary commodities, notably oil, low inflation in the international environment, restrictive fiscal policy at home and the persistently muted aggregate demand (which may also be affected by the slowdown in global growth) are conducive to low inflation. Despite the risks, we expect inflation to gradually rise and return within the target tolerance band in the second half of the year, aided also by past monetary policy easing.

Given that uncertainties surrounding movements in inflation emanate primarily from the international environment, the degree of monetary policy accommodation will depend mainly on the assessment of the inflationary effect of developments in international commodity and financial markets.

The next rate-setting meeting of the Executive Board will be held on 11 February 2016.

Press release from Executive Board meeting held on 11 February 2016

The NBS Executive Board decided in its meeting today to cut the key policy rate by 0.25 pp, to 4.25%.

The Executive Board also adopted amendments to the Decision on Interest Rates Applied by the National Bank of Serbia, narrowing the interest rate corridor from $\pm 2.0\%$ to $\pm 1.75\%$ relative to the key policy rate. The amendments were put through in an effort to contribute to further stabilisation of interest rates in the interbank money market, gradual reduction of the spread between the effective rate and the key policy rate, and strengthening of the interest rate transmission channel.

The Executive Board's decision was taken in consideration of the expected continuation of low inflationary pressures on account of the majority of domestic factors, as well as of weaker cost-push and demand-side pressures stemming from the international environment. The slackening of some emerging markets, notably China, which seems increasingly certain, could have negative effects on global demand and economic growth, especially as regards the pace of growth of Serbia's key trade partner – the euro area. The continuing decline in global prices of oil and other primary commodities and the subdued prospects for their growth in the period ahead also work towards easing inflationary pressures. In such circumstances it is even possible that the pace of normalisation of the Fed's monetary policy will be slower than expected earlier. Besides, the ECB eased its monetary policy again in December and announced the possibility of further accommodation in March.

The Executive Board assessed that year-on-year inflation will rise moderately from the middle of the year and return within the target tolerance band late this or early next year.

The National Bank of Serbia will continue to monitor closely the developments in the international environment and use all available instruments, to keep inflation low and stable, as this, together with preserving financial stability and a relatively stable exchange rate, is a precondition to accelerated but sustainable economic growth. Moreover, progress in fiscal consolidation and ensuring sustainability of public finances, improvement in the business and investment environment, and the narrowing of external imbalances will be of great assistance in moderating the effect of any external shocks.

The National Bank of Serbia expects that the continued monetary easing will lead to a further decline in lending rates and sustained recovery in lending, which will contribute to higher investment.

The Executive Board also adopted the February Inflation Report, which will be presented to the public on Friday, 19 February.

The next rate-setting meeting will be held on 17 March 2016.

CIP - Каталогизacija u publikaciji
Народна библиотека Србије, Београд

336.71(497.11)

INFLATION Report / National Bank of
Serbia. - 2006- . - Belgrade (Kralja Petra
12) : National Bank of Serbia, 2006- (Beograd :
Zavod za izradu novčanica i kovanog novca
"Topčider") . - 30 cm

Tromesečno
ISSN 1820-9394 = Inflation Report
(National Bank of Serbia)
COBISS.SR-ID 155775244