National Bank of Serbia

2010

May

INFLATION REPORT

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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 NBS prepares and publishes quarterly *Inflation Reports* as its main communication tool. The *Inflation Report* provides key economic facts and figures that shape the MPC'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 reasoning behind MPC's decisions and to provide an assessment of monetary policy effectiveness during the previous quarter. Also integral to this *Report* is inflation projection for at least four 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 task of the NBS.

The May *Inflation Report* was adopted by the NBS Monetary Policy Committee in its meeting of 11 May 2010.

Earlier issues of the *Inflation Report* are available on the NBS website (http://www.nbs.rs).

Monetary Policy Committee of the National Bank of Serbia:

Radovan Jelašić, *Governor*

Ana Gligorijević, *Vice Governor*

Bojan Marković, *Vice Governor*

Mira Erić-Jović, *Vice Governor*

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I. Overview

Inflation trended below the lower bound of the target in Q1. It is likely to fall short of the target in Q2 as well.

The slowdown in y-o-y inflation continued in Q1. Since early 2010 inflation has trended below the lower bound of the target, mainly in response to the persistently low aggregate demand, a drop in food prices and weaker pass-through of depreciation to inflation. In terms of quarterly data, however, inflation was on the rise (2%) primarily due to expected regulated price growth and seasonal growth in agricultural product prices.

The main drivers behind economic growth were rising public spending in Q1 and net exports over the last year.

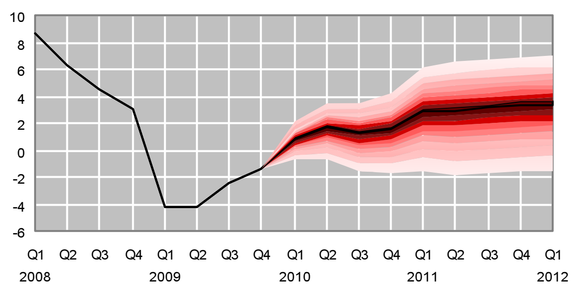
Domestic demand picked up somewhat in Q1, in response to accelerated growth in public spending spurred by rising expenditure for the purchase of goods and services. Investments and household spending, on the other hand, precipitated down. Though remaining dominant in y-o-y terms, the contribution of net exports to economic growth was fairly insignificant. GDP rose mildly, whereas NAVA stagnated. For the first time since Q4 2008, GDP recorded y-o-y growth in Q1 (1%).

Investments and increased net exports will lend the key boost to GDP growth and the economy's recovery from recession.

Positive contributions to GDP growth in the period ahead are expected from the increase in net exports (1.7 pp) and investments (0.9 pp) whose recovery will be led by the government's capital investment programme. Depressed public and personal spending, underpinned by plans to extend the freeze on public sector wages, poor real growth in economic sector wages and modest growth in bank lending activity, will continue to be the key disinflationary factor in the coming period.

Nonetheless, GDP growth will be modest in 2010 (around 1.5%) reflecting the global economy's sluggish emergence from recession and the weakness of domestic demand.

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



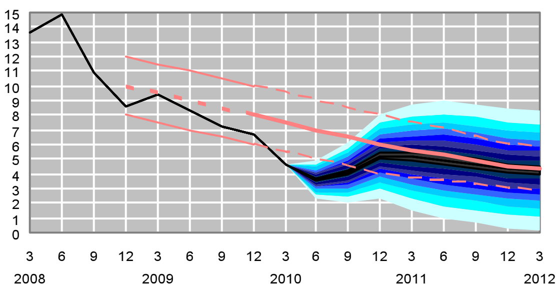
The healing of the economies of our key trading partners (eurozone and CEFTA members) could lead to a rise in Serbian exports given that the dinar depreciated most against the currencies of these countries. Nonetheless, despite Serbia's recovery this year, its GDP growth will be modest (around 1.5%) reflecting the global economy's sluggish emergence from recession and the weakness of domestic demand. No major step-up in economic activity is likely before 2011 (3.0%).

The degree of monetary policy expansiveness increased in Q1 mainly as a result of widened depreciation gap of the real exchange rate.

As announced in the previous Report, and in accordance with inflation projection and subsiding inflationary pressures, the NBS continued easing its monetary policy stance – since early 2010, the key policy rate has been lowered by 100 basis points. The degree of monetary policy expansiveness increased in Q1 largely as a result of weakening of the dinar and a wider depreciation gap of the real exchange rate. On the other hand, though the key policy rate was lowered and moved below the neutral point, the real interest rate went up from the previous quarter due to a steeper decline in inflation expectations.

In H2 2010 inflation will gradually retreat within the target tolerance band and hover around the target throughout 2011.

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



After undershooting its lower bound in H1, inflation will gradually retreat within the target tolerance band in H2 and will hover around the target throughout 2011, largely under the impact of the past depreciation of the dinar and the halted decline in food prices. At the same time, low aggregate demand, sustained by freeze on public sector wages and pensions will act as a damper on any further inflation growth.

The key risks to inflation projection are those relating to food prices, risk premium, the exchange rate pass-through to inflation and the speed of economic recovery.

As in the previous projection, the key risks to the current projection are those relating to the risk premium, exchange rate pass-through to prices and the speed of economic recovery. Moreover, with a gradual recovery of global and domestic economy and amid potentially weaker agricultural performance, food prices are likely to grow perceptibly.

The key policy rate is more likely to be lowered in the coming period than kept on hold.

Based on the current inflation projection and its underlying risk factors, the NBS Monetary Policy Committee judges that the key policy rate is more likely to be lowered in the coming period than kept on hold (8.0%). The lowering of the key policy rate, however, will be slower than in the prior period. Furthermore, should inflationary pressures (stemming from food prices and exchange rate pass-through to prices) and recovery of aggregate demand prove stronger than anticipated, the process of monetary easing may even be halted altogether.

II. Monetary policy since the February *Report*

The degree of monetary policy expansiveness increased in Q1 as a result of further lowering of money market interest rates and widening of the depreciation gap of the real exchange rate.

As announced in the previous *Report*, and in accordance with inflation projection and subsiding inflationary pressures, the NBS continued easing its monetary policy stance. In 2010, the key policy rate was lowered on three occasions – each time by 50 basis points, and currently stands at 8.0% p.a.

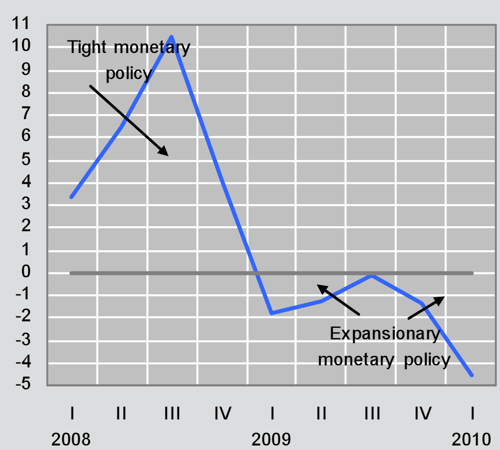
Further lowering of the key policy rate in Q1 will not have that much of an impact on the achievement of inflation target in H1, but rather in H2 and in 2011. This means that inflation will most likely hover below the lower bound of the target tolerance band throughout H1 in which case, i.e. departure from inflation target for six consecutive months, the NBS will have to write a letter to the government explaining the reasons for such departure, proposing measures to be taken and specifying the time horizon needed to bring inflation back to the target.

The Monetary Policy Committee's decision to continue lowering the key policy rate despite further depreciation pressures was based primarily on the persistently strong disinflationary effects stemming from low domestic demand. The MPC assessed these effects as stronger than assumed in the previous Report and was soon proved right – according to official statistics, GDP decline in 2009 measured 3% vs. 2.8% estimated earlier. The decision on further lowering of the key policy rate was also underpinned by the easing of inflation expectations, smaller than expected exchange rate pass-through to core inflation and continued decline in food prices.

As on earlier occasions, the National Bank's interventions in the foreign exchange market were not geared to impact either the level or trend of the exchange rate. During the first quarter, the National Bank sold EUR 631.5 million in order to bolster trading in the interbank foreign exchange market, ensure uninterrupted functioning of the foreign exchange market and prevent excessive daily volatility of the exchange rate of the dinar.

In the course of Q1, the Monetary Policy Committee adopted a new decision on reserve requirements for banks that entered into force on 18 March. The reserve base was expanded (the number of exemptions from reserve requirements was reduced), the reserve requirement ratio on the dinar base was cut to 5%, and the ratio on the foreign currency base was unified (25%). Banks will no longer be required to allocate reserves against new foreign borrowing and foreign currency savings deposits

Chart II.0.1 **Monetary Conditions Index**



The degree of monetary policy expansiveness increased in Q1.

if the sum of foreign currency required reserves allocated in the prior period turns out to be higher than the sum of required reserves calculated by applying the new ratio. Any surplus allocation of foreign currency required reserves will be returned to banks in three monthly instalments beginning from February 2011. Changes in the reserve requirements envisaged by the new decision will be gradually phased in so as not to cause any major pressure on either dinar or foreign currency liquidity of banks. The reserve requirements are now better structured and will contribute to greater transparency of monetary policy. Besides, banks are encouraged to accumulate savings deposits and to borrow abroad to fund lending to the private sector.

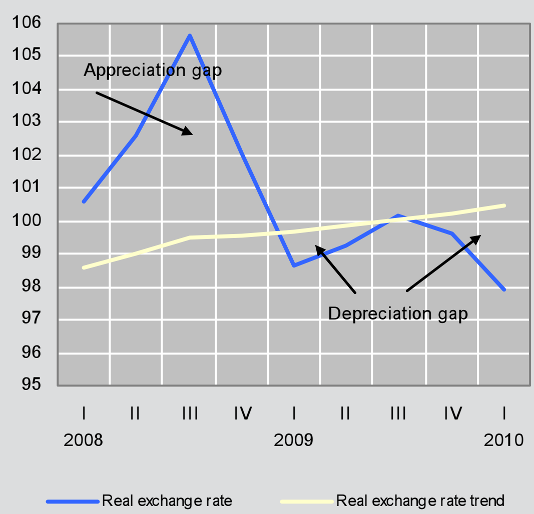
Monetary policy stance is determined not only by the character of decisions taken by the Monetary Policy Committee, but also by how market participants respond to them. Judging by the movements of the real MCI[1], the degree of monetary policy expansiveness increased in the course of Q1.

Depreciation gap of the real exchange rate – one of the two MCI components – that opened in Q4 2009, has widened further in Q1 2010 as a result of 4.2% average nominal depreciation of the dinar and smaller than expected exchange rate pass-through to inflation.

The second MCI component – real interest rate on two-week BELIBOR – remained below the neutral level in Q1. Its trend declined amid further drop in the country risk premium and record low interest rates abroad. The decline in trend, however, was not accompanied by the decline in real interest rate. Instead, real interest rate went up as a consequence of steeper decline in inflation expectations than in nominal interest rate. As a result, real interest rate, though below the neutral level, generated weaker inflationary pressures than a quarter earlier.

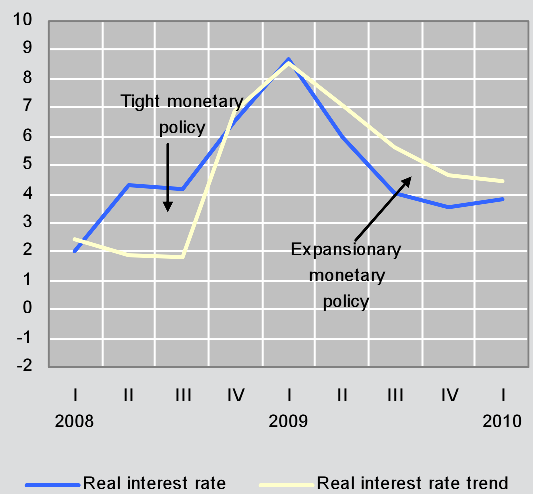
Based on the current inflation projection and its underlying risks, the key policy rate is more likely to be lowered in the coming period than kept on hold.

Chart II.0.2 **Real exchange rate and its trend**
(base index)



Depreciation gap of the real exchange rate widened in Q1.

Chart II.0.3 **Real interest rate and its trend**
(in %)



Real interest rate was running below the trend.

[1] Real Monetary Conditions Index.

III. Inflation developments

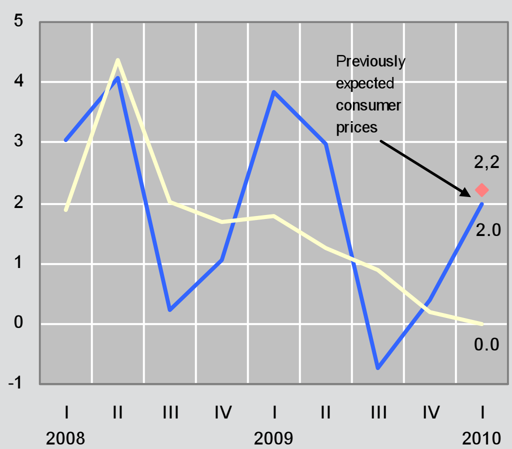
Y-o-y inflation continued to decelerate in Q1 and trended below the lower bound of the target. Quarterly inflation was on the rise in response to growing regulated and agricultural product prices, whereas market-based prices stagnated mainly on account of a further decline in processed food prices.

It is estimated that inflation in Q2 2010 will move below the lower bound of the tolerance band.

Inflation developments in Q1

A somewhat lower than expected growth in Q1 inflation was primarily due to a further drop in food prices and weak aggregate demand.

Chart III.0.1 **Price movements**
(quarterly growth, in %)



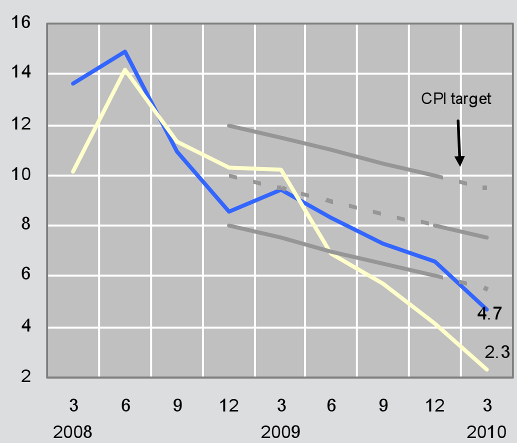
Headline inflation continued up in Q1, while core inflation further slowed down . Growth in headline inflation was spurred by regulated and agricultural product prices.

Prompted mainly by lower growth in market-based prices, y-o-y consumer price growth continued to decelerate, trending below the lower bound of the target.

In quarterly terms, consumer price growth sped up from 0.4% in Q4 2009 to 2.0% in Q1 2010, chiefly as a result of regulated price growth typical for Q1, as well as a seasonal hike in agricultural product prices.

Furthermore, although depreciation pressures continued throughout Q1, the ensuing inflationary pressures were weaker than expected, leading to unchanged core inflation.

Chart III.0.2 **Price movements**
(y-o-y growth, in %)



Y-o-y growth in headline and core inflation continued decelerating. Core inflation was at a much lower level than headline inflation.

Such an outturn of core inflation was largely unexpected and came mainly in response to declining food prices. Processed food prices fell by 2.2% primarily due to falling

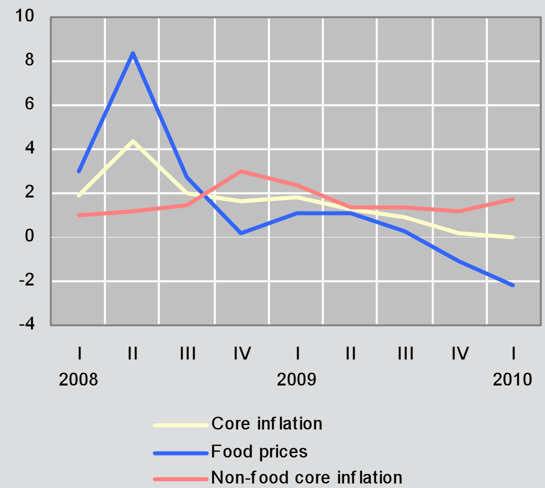
Table III.0.1 **Price indicators**
(growth rates, in %)

	VI 2009 / VI 2008	IX 2009 / IX 2008	XII 2009 / XII 2008	III 2010 / III 2009
Consumer prices	8.3	7.3	6.6	4.7
Core inflation	6.9	5.7	4.1	2.3
Retail prices	9.8	9.5	10.4	7.4
Cost of living	7.8	7.1	6.6	4.4
Industrial producer prices	6.6	5.3	7.4	11.7
Agricultural producer prices	-9.4	-8.9	-4.8	-9,4*

* February on February

All price indicators, except industrial producer prices, point to a lower y-o-y price growth at end-Q1.

Chart III.0.3 **Core inflation by component**
(quarterly growth, in %)



Core inflation remained unchanged in Q1 as the decline in food prices offset the growth in non-food core inflation.

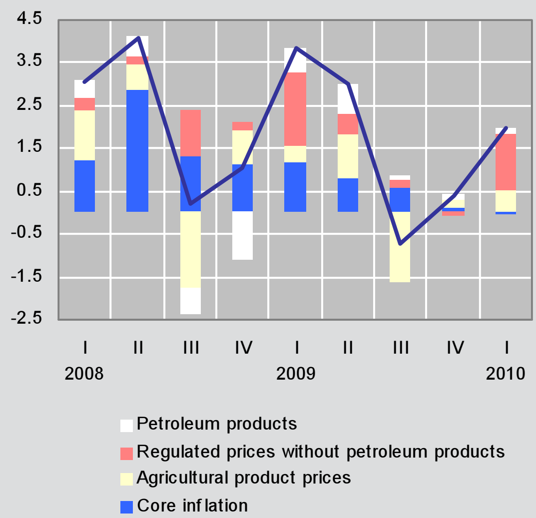
fresh meat prices. On the other hand, core inflation excl. food climbed to 1.7%, partly on account of weakening of the dinar. However, owing to very low aggregate demand, it was not possible for the producers and traders to pass through depreciation to end-consumers to any appreciable extent. At end-Q1 y-o-y core inflation reached 2.3%.

Table III.0.2 **Consumer price growth by component**
(by quarter, in %)

	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1
Consumer prices	3.8	3.0	-0.7	0.4	2.0
Core inflation	1.8	1.2	0.9	0.2	0.0
Prices of agricultural products	4.7	13.1	-18.5	2.7	7.0
Regulated prices	9.1	4.4	1.1	0.5	5.5
Electricity	0.0	0.0	0.0	0.0	11.5
Petroleum products	16.9	17.9	2.3	3.5	3.0
Gas for households	-0.8	0.1	0.0	0.2	0.0
Utilities	12.8	3.1	6.0	1.0	4.2
Social welfare services	0.9	1.8	3.3	8.7	3.7
Transport services (regulated)	26.6	0.4	0.0	0.1	2.3
Postal and telecommunications services	10.1	0.0	1.9	0.0	0.0
Bread	-0.7	-4.1	0.6	-2.8	-0.8
Cigarettes	15.0	0.0	0.0	0.0	10.2
Medications	10.1	10.3	-1.3	-2.7	0.2
Other	0.7	9.7	0.1	0.0	0.6

The sharpest rise in Q1 was recorded with prices of electricity, cigarettes and agricultural products.

Chart III.0.4 **Contribution to quarterly consumer price growth**
(in percentage points)



Regulated prices (petroleum products excluded) provided the largest contribution to consumer price growth in Q1.

Regulated price growth accelerated in Q1, with rising energy prices (mainly electricity) accounting for more than half of the growth. Hikes in cigarette and public-utilities prices provided significant impetus to regulated price growth. This growth, on the overall, would have been even higher but for the lowering of prices of petroleum products by some dealers below the maximum level agreed. Regulated price movements since early 2010 have been in line with our expectations and the framework planned for 2010. Y-o-y regulated price growth at end-Q1 reached 11.7%.

The expected seasonal growth in agricultural product prices came to 7% in Q1. Growth in these prices reached 1.7% y-o-y in March.

Inflation expectations

One-year ahead inflation expectations eased from a quarter earlier and moved closer to targeted inflation.

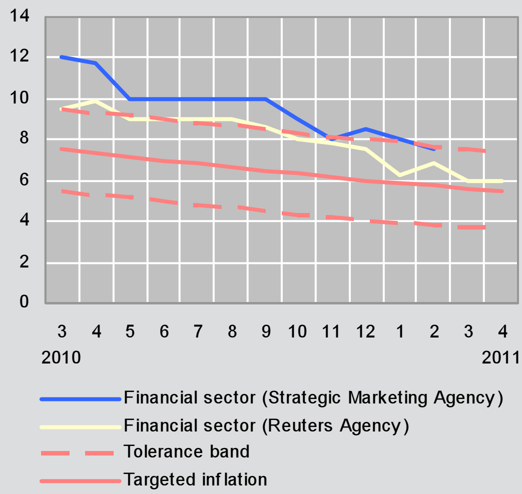
As indicated by the February Strategic Marketing survey, one-year ahead inflation expectations of the financial sector edged down from the previous quarter, but stayed right on the upper bound of the tolerance band. Expectations of corporate and trade union sectors picked up somewhat, while those of households remained unchanged.

According to the Reuters survey, end-Q1 inflation expectations of the financial sector declined relative to end-2009.

The April Reuters survey shows that financial sector expectations showed no change from March, equalling 6% for the year ahead and moving slightly above the April 2011 targeted inflation.

The MRI[2] survey conducted in early April and encompassing a number of entrepreneurs, shows that around a half of all surveyed producers have announced price hikes in the coming six months. Such expectations, however, are not as worrying as may seem at first sight. For instance, if a half of all entrepreneurs were to raise their prices by 5%, core inflation would climb to 2.5% over the future six months, which however would not be worrying given the current economic backdrop.

Chart III.0.5 **One-year ahead expected and targeted inflation**
(in %)



One-year ahead inflation expectations of all sectors continue declining.

Expectations for Q2

In Q2, inflation is expected to move below the lower bound of the tolerance band.

It is estimated that y-o-y consumer price growth in Q2 will hover below the lower bound of the target, reaching around 3.6% in June (June target being 7.0 ± 2%).

Consumer price growth in Q2, projected at ca 2.0%, will be equally driven by the seasonal growth in agricultural product prices and the increase in market-based and regulated prices.

Quarterly growth in core inflation is expected to accelerate primarily due to a halted decline in processed food prices as the effects of past cuts of input prices were

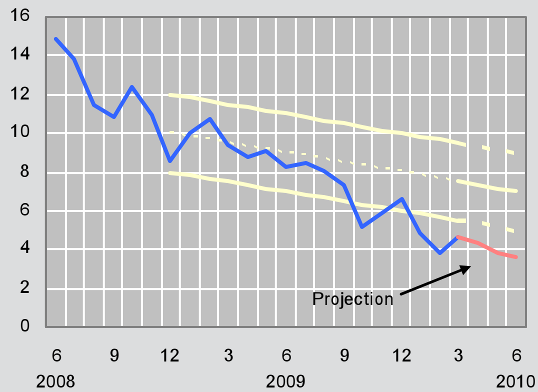
[2] Market Research Institute.

Table III.0.3 **Major revisions of regulated prices expected in Q2**

	Growth rate (in %)	Contribution to consumer price growth (p.p.)
Medications	7,0	0,2
Petroleum products	4,0	0,2
Transport services (regulated)	4,0	0,1
Utilities and housing services	2,0	0,1
Other	12,0	0,1

Regulated price growth is expected to be slower than in Q1.

Chart III.0.6 **Short-term inflation projection**
(y-o-y growth, in %)



Y-o-y inflation is expected to fall further in Q2 and revolve below the lower bound of the target tolerance band.

largely exhausted. Further, prices of non-food products may rise due to the pass-through effect of higher prices of energy products, depreciation of the dinar and introduction of the ecological tax on technical appliances.

Regulated price growth is likely to slow relative to Q1 (2.5%). Prices of medicaments are expected to rise (due to depreciation of the dinar), as well as prices of petroleum products (on the back of rising prices of crude oil and the stronger dollar), prices of transport and utilities and housing services and prices of telephone and TV subscription.

Growth in agricultural product prices is estimated to be more robust due to the supply of seasonal products in the market. This product group is the most prone to the risk to projection.

Given the persistently weak aggregate demand and its disinflationary effect, as well as declining inflation expectations, the coming period is not likely to see more appreciable price hikes. However, risks remain as to the exchange rate and food prices.

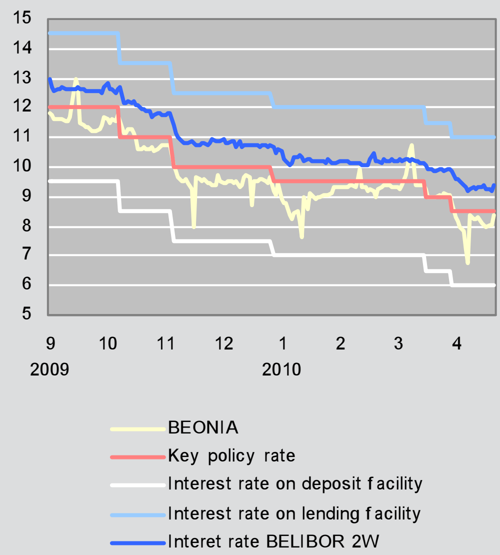
IV. Inflation determinants

1. Money market developments

Interest rates

A downward trend in interbank money market interest rates was temporarily discontinued due to the seasonal contraction in bank liquidity. Bank interest spreads picked up mildly relative to Q4.

Chart IV.1.1 **Interest rate movements**
(daily data, p.a, in %)



BEONIA edged up in Q1 despite the key policy rate cut.

Lowering of the key policy rate by end-2009 was followed by cuts in money market interest rates in early January 2010. Still, the seasonal contraction in bank dinar liquidity prompted borrowing in the interbank money market on a larger scale and fed through into a moderate increase in BEONIA in February and March. At end-Q1, BEONIA trended above the NBS key policy rate. At the same time, the BELIBOR one-week rate remained basically unchanged, whereas the rate for longer maturities declined slightly.

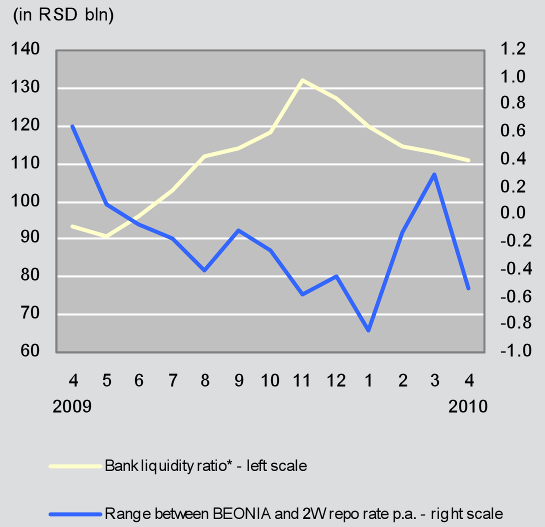
Amendments to the Decision on Banks' Required Reserves enabled a release of over RSD 21 billion to banks in April. This release, together with an increase in dinar corporate and household deposits, helped buoy up the overall liquidity of the banking sector. Such developments triggered a further slump in money market interest rates, most notably those of shorter maturities. At end-April, BEONIA touched 8.4% and BELIBOR ranged between 9.2% and 9.9% for different maturities.

Due to their limited issue, interest rates on T-bills for all maturities were heading down until March. From March onward, the government stepped up borrowing in the domestic market at longer maturities. Increased primary issue of bills, however, did not entice heightened investor demand. To maximise sale, the government set the effective rate at the level much closer to the maximum offered rather than the average rate, which temporarily halted the fall in T-bill interest rates.

Cuts in the key policy rate on 23 March and 8 April by 50 b.p. each had a limited impact on movements in T-bill interest rates. From the March reduction in the key policy rate until the end of April, the rates for 6-month and 1-year maturities declined by 50 b.p. (to 9.0%) and 40 b.p. (to 9.49% at the auction on 6 May) respectively.

The main objective of the auction organised by the NBS on 19 April was outright sale of RS bonds maturing at year-end, in the nominal amount of RSD 10.7 billion. The bonds were sold at the weighted average interest rate of 8.9%. The demand for bonds, however, was two and a half times higher than the volume offered for sale indicating that T-bill interest rates are likely to decline further in the coming period.

Chart IV.1.2 **Bank liquidity and range between BEONIA and the key policy rate**



* Bank liquidity is calculated as the ratio of bank average liquid assets (free reserves, repo stock with the NBS and net purchase of T-bills in the current month) and transaction deposits.

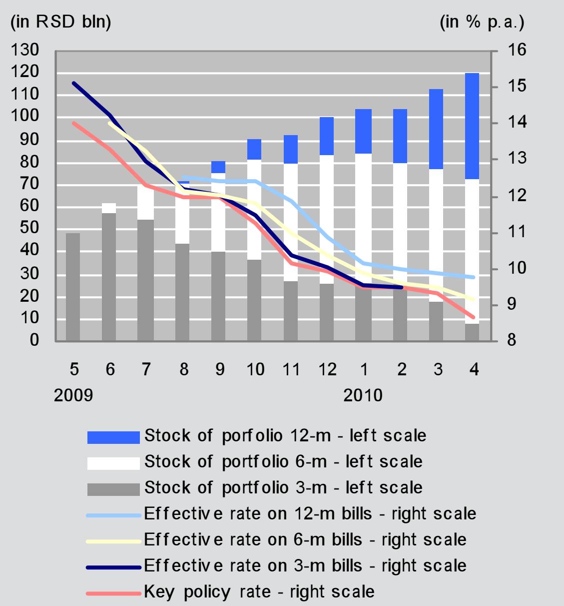
The Q1 rise in BEONIA is directly attributable to deteriorated liquidity of the banking sector.

The announced issue of longer term government bills (18 and 24 months) will have a positive impact on further development of secondary trading, i.e. it will help improve liquidity of the market for government securities. At the first auction, all of the 18-month T-bills were sold out and the auction closed at the effective rate of 9.49%. This gives us reason to believe that demand at T-bill auctions will henceforth rise, leading to stronger market influence on effective rates.

Interest rates on corporate and household loans rose in the year to February. Activity on the unsubsidised segment of the lending market weakened somewhat in this period, whereas the disbursement of subsidised loans under the Programme came to a halt. Increased supply of loans in March pushed lending interest rates down to 15.4%. The rates, however, remained higher by 0.3 pp relative to end-2009.

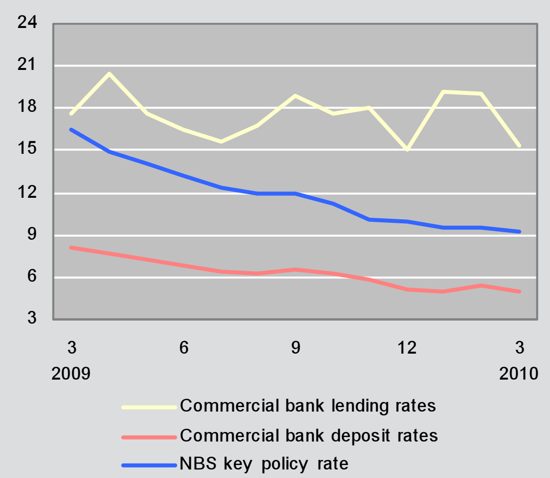
In terms of dinar loans, interest rates on the newly approved corporate loans continued down from March 2009. Within the composition of the newly approved dinar household loans, interest rates on cash loans declined somewhat, whereas a rise in current account overdraft rates, particularly pronounced in early year, prompted a shift in the trend of dinar household loan rates.

Chart IV.1.3 **Effective rates on T-bills and the stock of portfolio**



Effective rates on T-bills did not not fully mirror the cut in the key policy rate.

Chart IV.1.4 **NBS key policy rate and commercial bank interest rates***
(weighted average, p.a, in %)



* Lending interest rates refer to both foreign currency-indexed and dinar loans.

The interest rate spread widened amid a mild increase in lending and a decrease in deposit rates.

Weighted average interest rates on dinar and foreign exchange savings with banks edged down slightly in March relative to Q4 to around 4.9%.

Monetary aggregates

Demand for money receded under the influence of seasonal factors.

Reserve money contracted in Q1 by 17.3% in real terms. The withdrawal of reserve money was effected largely via the dinar channel although the FX channel played a role too.

Reduction in capital, positive exchange rate differentials and rising balances in government accounts impacted on a decrease in reserve money, with subdued bank investment in repo securities acting in the opposite direction.

NBS interventions in the interbank foreign exchange market led to a reduction in foreign exchange reserves and withdrawal of reserve money. Neither regular inflows nor WB, EBRD and EIB loans sufficed to neutralise the outflow occasioned by interventions.

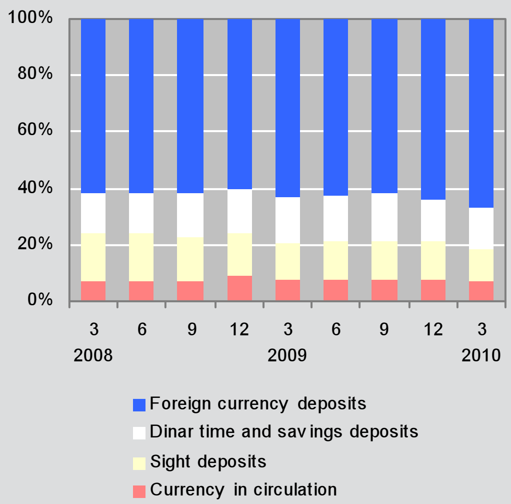
All monetary aggregates declined in real terms relative to end-2009 – M1, M2 and M3 shrank by 14.6%, 9.4% and 1% respectively. Contracted money in circulation and corporate demand deposits were the decisive factors behind the reduction in money aggregates. The balance on term dinar deposits remained largely unchanged, while M3 was the only aggregate that experienced a nominal increase in response to rising FX deposits.

Growth in FX deposits with banks, distinctly lower from Q4, was prompted by an upturn in FX household savings. Balances in both dinar and FX enterprise accounts were slashed. Settlement of external liabilities, procurement of means for a new production cycle, as well as lower interest rates on savings deposits dragged down on corporate deposits.

Improved velocity of money relative to Q4 reveals depressed demand for money, driven largely by seasonal factors.

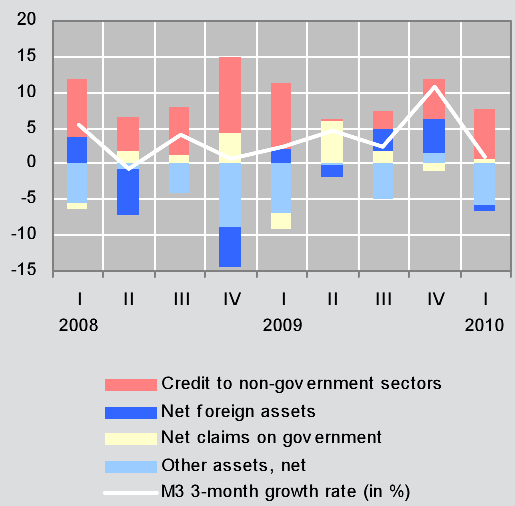
Growth in M3 was aided primarily by bank lending (6.9 pp). An upward push also came from the government activity (0.7 pp) as the government debt with banks in respect of T-bills sale outstripped the increase in deposits with the NBS.

Chart IV.1.5 **M3 Composition**



The share of sight deposits and currency in circulation decreased, while the share of foreign currency deposits rose.

Chart IV.1.6 **Contribution to M3 growth**
(in percentage points)



Bank lending continues to provide the largest contribution to M3 growth.

Despite the quarterly decline, money supply rose in y-o-y terms. Relative to March 2009, M1, M2 and M3 rose by 2.3%, 2.1% and 14.6% in real terms respectively.

Reserve money continued down in April. The outright sale of RS bonds from the NBS portfolio, rising investments in repo securities and meagre growth in government deposits with the NBS neutralised the effect of reserve money creation against FX transactions. For the first time in the year, owing to growth in dinar term and demand deposits, M1 and M2 went up in April and M3 continued to grow.

Bank lending

Following stagnation in January and February, March saw a recovery in bank lending volumes. The quarterly rise, however, edged up slightly from a quarter earlier.

Total lending picked up in Q1 by 2.3% in real terms, of which corporate sector accounted for a 2.4% rise and household sector for 2.2%. Such movement was only a slight improvement on Q4 when real growth in overall lending reached 1.9%.

Early 2010 ushered in stagnation in lending – the growth recorded in January and February was driven not by the real increase in lending, but largely by the effects of depreciation of the dinar. March, however, saw more positive trends, with growth relying almost entirely on the effective increase in lending volumes.

In y-o-y terms, real slowdown in lending was discontinued but no signs of stronger recovery emerged. Y-o-y growth rates in lending to the private sector have been lingering at around 9% over the past several months by contrast to ca 22% at end-2008 when the slowdown process took hold.

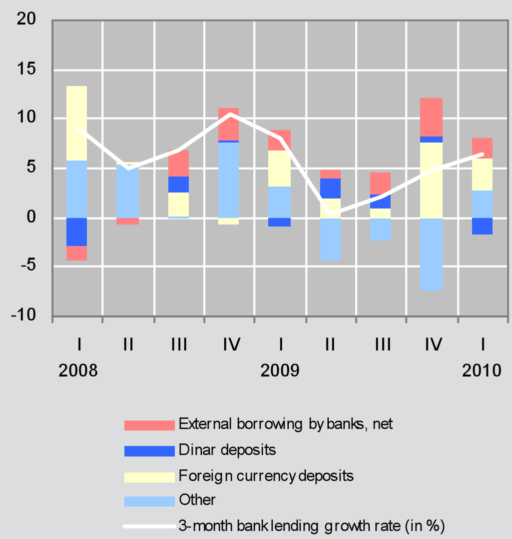
Q1 was marked by nominal growth in lending (6.4% or RSD 81.7 billion), financed from domestic rather than foreign sources as funds held by banks with the NBS were decreased and household foreign exchange deposits increased (contribution of 3.2 pp each). Growth in net foreign borrowing by banks (EUR 142 million) lent a 2.1 pp boost to the overall increase in lending volumes.

Lending to the corporate sector rose by RSD 51.8 billion in nominal terms or, excluding the effect of dinar volatility, by RSD 27 billion. Public enterprises failed to draw any significant loan amounts (nominal rise of RSD 3.3 billion), while other enterprises accounted for the largest portion of corporate loans. In addition to the expected growth in liquidity loans, Q1 saw a robust growth in loans for investment purposes. A sectoral breakdown shows the largest volume of loans extended to enterprises in the trade, industry and transport sectors.

A decline in foreign indebtedness by enterprises throughout 2009 did not subside in Q1 either – cross-border loans declined by EUR 99.8 million in net terms (RSD 9.8 billion).

Household lending stepped up by RSD 24.4 billion nominally or, after the exclusion of the effect of dinar volatility, by RSD 11.1 billion in real terms. Housing loans recorded the strongest growth, followed by consumer and cash loans, whereas current account overdrafts remained flat.

Chart IV.1.7 **Contribution to bank lending growth**
(in percentage points)



Banks financed their lending activity from the increase in foreign currency savings and decrease in their reserves with the NBS .

Table IV.1.1. **Subsidised loans**

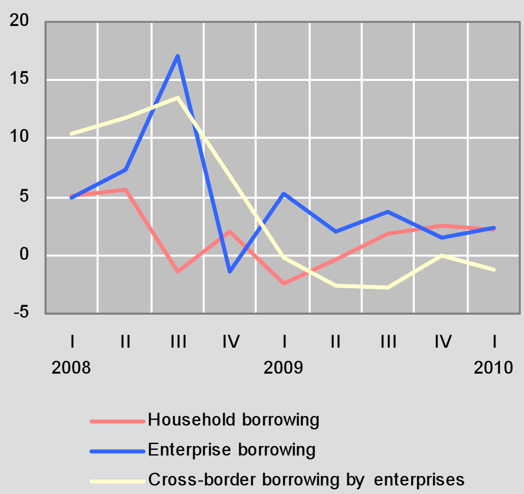
Government Programme of Measures for Mitigating the Effects of the Global Financial Crisis

	2009*			2010*		
	Approved	Funds earmarked under the Programme	Execution percentage	Approved	Funds earmarked under the Programme	Execution percentage
	(in RSD bln)			(in RSD bln)		
Total	104.9	117	89.6	25.7	85	30.3
Liquidity	88.7	80	110.9	22.5	50	44.9
Investment	0.2	17	1.3	0.4	15	2.9
Consumer	15.9	20	79.7	2.8	20	14.2
Subsidised housing loans (in RSD bln)						
	2009			**2010****		
Total approved	2.1			3.2		

* Data for 2009 relate to loans approved under the Programme for 2009, including those approved in the first half of January 2010. Data for 2010 refer to loans approved under the Programme for 2010, i.e. loans approved in February and March 2010.
** January–March 2010.

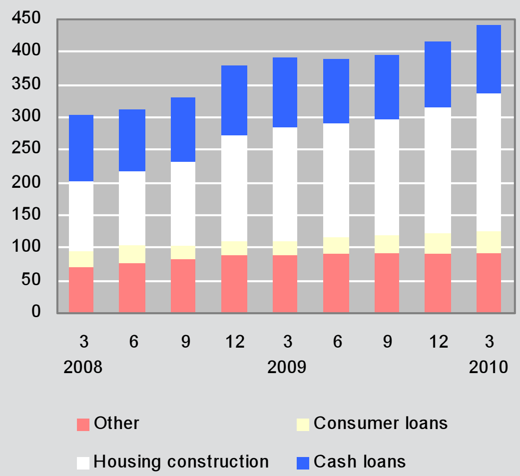
Source: Ministry of Economy and Regional Development and National Mortgage Insurance Corporation.

Chart IV.1.8 **Real domestic and cross-border borrowing**
(quaterly grow th rate in %)



Lending picked up slightly in Q1.

Chart IV.1.9 **Composition of loans extended to households**
(in RSD bln)



Housing loans continue to record the strongest growth. A mild increase was registered in consumer and cash loans.

A step-up in the subsidised segment of the market was quite significant in terms of the overall activity of banks. The share of subsidised loans in fresh lending climbed to 23.8% in March (ca 10% during 2009). Following stagnation in January and February, lending intensified in March. Under the Government Programme of Measures to Mitigate the Negative Effects of the Global Financial Crisis, ca RSD 5 billion of loans were approved in January and February, whereas March saw a hike of RSD 23.3 billion. Further, in the year so far, banks have approved RSD 3.2 billion in government-subsidised housing loans, in more or less equal monthly amounts.

The share of NPLs rose by 0.7 pp relative to end-2009 and reached 9.3% in March.

In Q1, the share of private sector loans in GDP rose to 45.1%, but despite the obvious upward tendency (up by 2 pp and 3 pp relative to end-2009 and Q1 2009 respectively) remains low by comparison to the neighbouring countries.

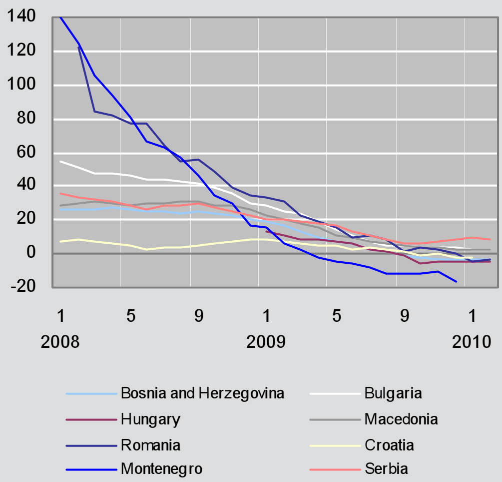
Text box 1: Bank lending across the region in 2009

The contraction in bank lending is one of the side effects of a crisis culminating with recession. In most countries it manifested as a real decrease in the volume of loans approved, and in few cases only as a slowdown in growth.

Despite substantial stimulus measures (policy rate cuts, lowering of reserve requirements, etc.), most countries in the region recorded negative real lending growth rates[1] at end-2009. The exceptions in this respect were Serbia, Bulgaria and Macedonia, where real lending growth rates fell sharply from their pre-crisis levels, but still remained positive. Of the three countries, Serbia recorded the smallest slowdown in lending. The subsidised loan programme is believed to have contributed only partly to these reservedly positive movements in Serbian lending as the share of these loans in total lending averaged around 10% in 2009.

After bringing capital flows to a sudden stop, the global crisis induced a change in their direction, thereby putting a strain on the sources of finance for banks. In nearly all countries, net foreign sources of funding provided a negative contribution to lending growth. In other words, tighter access to foreign sources of finance, as well as the withdrawal of deposits from banks by their parent banks, played a significant role in the contraction of lending in most of the countries under review. Of the countries registering no real decline in lending, a positive contribution of the foreign sources of finance was registered in Serbia only. This was due to the adherence to the Vienna Agreement, but also to the abolishment of reserve requirements on new foreign borrowing. Besides, the highest interest rates in the region make Serbia very attractive in the eyes of foreign financial investors.

Real domestic lending
(y-o-y growth rates, in %)



Source: central bank websites.

[1] Real lending was calculated by taking into account consumer price growth, share of foreign currency-clause indexed loans and changes in the exchange rate of the dinar.

2. Movements in the foreign exchange market and the exchange rate

The dinar's slide against the euro continued in Q1. With trading volumes in the interbank foreign exchange market at a low level, the NBS intervened by selling its foreign exchange holdings.

The weakening of the dinar against the euro continued in Q1. Despite NBS interventions, the dinar weakened most in January and February, but achieved some stability in March. The dinar's depreciation averaged 4.2% and the exchange rate moved between 96.0 to 99.9 dinars for one euro.

Such movements were due to several factors, including seasonal increase in enterprise demand for foreign exchange, still very modest inflow of foreign capital, banks' net repayment of short-term foreign debt, sluggish growth in household foreign currency savings, and much lower than expected purchase of foreign cash from licensed exchange dealers in January and February.

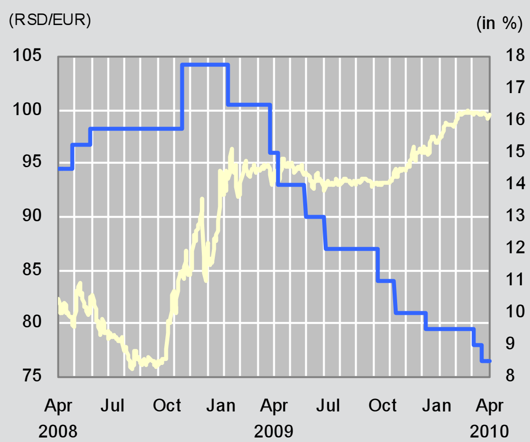
The dinar also softened against the US dollar (by around 10%). With 5.6% weakening of the nominal effective exchange rate of the dinar[3] and faster growth in domestic relative to foreign prices, Q1 saw real effective depreciation of the dinar of 4.4% (2.9% against the euro and 9.4% against the dollar).

IFEM trading volumes remained low – average daily turnover was less than EUR 30 million, and the exchange rate of the dinar displayed excessive volatility on some days. In Q1, the National Bank of Serbia sold to banks EUR 631.5 million (most of which in January – 245.5 million).

In late March, the National Bank of Serbia decided to introduce three-month foreign exchange swap auctions (weekly, at market prices). In all auctions organised to date, banks acted not only as buyers, but also as sellers of foreign exchange to the NBS.

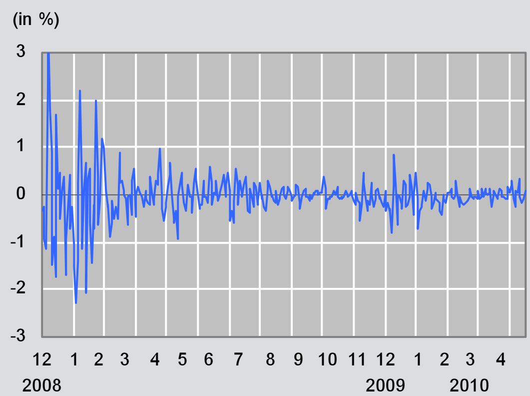
The dinar strengthened mildly against the euro in April (0.3% on average) as a result of lower sale of foreign exchange to enterprises, higher purchase of foreign cash

Chart IV.2.1 **Movements in RSD/EUR exchange rate and 2W repo rate**



Depreciation pressures resulted to a certain extent from the cumulative effects of monetary easing in the prior period.

Chart IV.2.2 **Daily changes in RSD/EUR exchange rate***

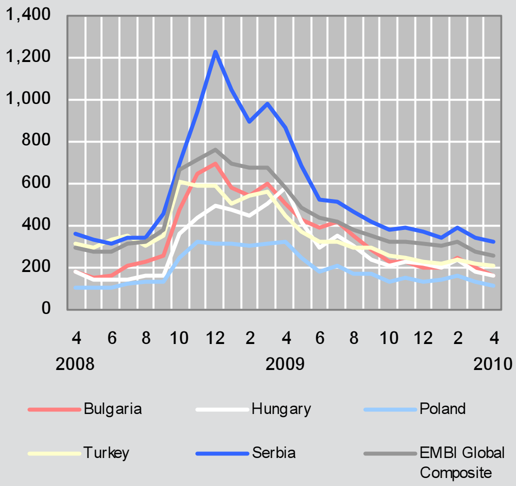


* Negative rates indicate depreciation and positive rates appreciation of the dinar.

Though the exchange rate of the dinar weakened in Q1, its daily volatility was less pronounced than a quarter earlier.

[3] Weights: 0.8 for the euro and 0.2 for the US dollar.

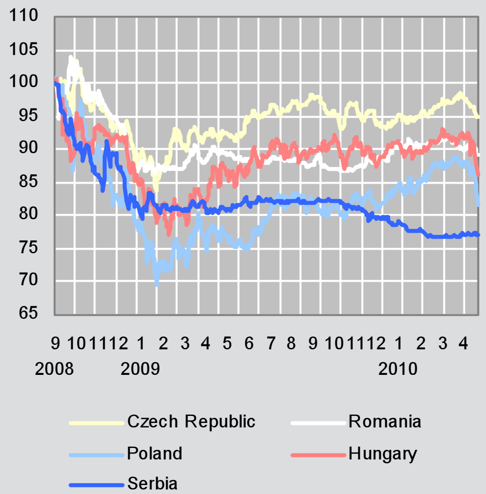
Chart IV.2.3 **Risk premium indicator – EMBI by country**
(monthly averages, in basis points)



Source: JP Morgan.

In all of the selected countries, the risk premium rose slightly in February, and then headed down in March and April.

Chart IV.2.4 **Movements in exchange rates of national currencies against the euro**
(Sep 30, 2008 = 100)



Only the dinar fell against the euro in Q1. Since early May, however, all currencies weakened.

from exchange dealers, and stronger growth in household foreign currency savings. Interbank trading in the IFEM edged up (to above EUR 30 million per day).

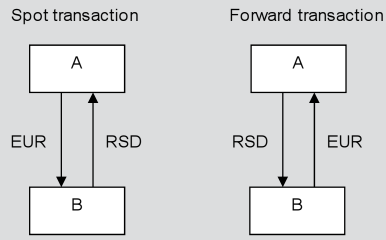
Risk premium, measured by EMBI, recorded a mild increase from mid-January to mid-February, but henceforth headed down to reach 326 basis points at end-March. Already in April, the risk premium headed up, reaching 344 basis points at the end of the month. Similar movements in EMBI were recorded for other transition countries too.

In early May, however, countries in the region, Serbia included, saw a rise in risk premiums on account of the Greek crisis and their national currencies succumbed to the downward pressure.

According to the Reuters survey carried out in May, the financial sector expects stable exchange rate of the dinar over the period ahead.

Text box 2: Three-month FX swap auctions

Forex (FX) swap is a simultaneous purchase and sale of identical amounts of one currency for another with two different value dates (normally spot to forward). In the swap transactions the NBS carries out with domestic banks, the first leg (spot) is performed two business days from the day of concluding the transaction (spot currency date T +2), while the second leg (forward) is performed three months after the spot date.



The differential between the spot and forward exchange rates is determined by the differential between interest rates on the two currencies swapped (interest rate parity theory). This differential is designated as the forward margin or swap points. What the market-determined swap points will eventually be worth may, in certain situations, depend on the expected exchange rate change, but the interest rate differential will retain its crucial role.

$$\text{Swap points} = \text{spot exchange rate} * \left[\frac{1 + \left(\frac{K_2}{100} * \frac{D}{360} \right)}{1 + \left(\frac{K_1}{100} * \frac{D}{360} \right)} - 1 \right] * 10.000$$

$$\text{Forward exchange rate} = \text{spot exchange rate} + \frac{\text{swap points}}{10.000}$$

K_1 – annual interest on EUR, with two decimal places

K_2 – annual interest on RSD, with two decimal places

D – transaction maturity

The party that obtains a higher interest paying currency in the first leg of the swap transaction must pay swap points to its counterparty in compensation for the currently low currency yield.

FX swaps were first introduced in May 2009 as the National Bank of Serbia's measure of support to financial stability. The aim of two-week FX swaps was to provide banks with access to additional sources of dinar and foreign exchange liquidity at a pre-determined price, in order that they may overcome temporary liquidity problems. In such an arrangement, the NBS was to play the role of the lender of last resort. These swaps however attracted very little interest as they were not competitive in the market.

In April 2010 the NBS initiated auctions of longer maturity (three months) foreign exchange swaps. These two-way auctions are held weekly, on Tuesdays, and involve both purchase and sale. They are executed at market prices, i.e. swap points, but involve a limited quantity of foreign exchange. The aim of three-month FX swap auctions is to facilitate banks' long-term liquidity management and also give impetus to the interbank swap market. The weighted swap points that the market players are prepared to pay and/or charge on three-month transactions will serve as a price signal for longer maturities.

Banks have shown great interest in this instrument and in nearly all auctions demand by far outstripped supply (EUR 10 million per auction).

Results of three-month FX swap auctions
(in EUR mln)

Date	Swap purchase	Average swap points	Swap sale	Average swap points
6 April 2010	10.0	18,907	9.2	17,676
13 April 2010	10.0	17,634	10.0	17,618
20 April 2010	10.0	18,062	10.0	17,024
27 April 2010	10.0	17,696	10.0	16,932
4 May 2010	2.5	17,760	10.0	15,196

Excess demand, as well as the swap points offered by banks, point to potential for interbank trading without NBS intermediation. Note that weighted average swap points charged by the NBS were in all auctions higher than those it paid.

The NBS plans to engage in these transactions for a limited period of time. Its aim is to encourage the development of interbank FX swap trading, while at the same time fostering the FX hedging market and ensuring dinar and foreign exchange liquidity of the interbank market.

Of other inflation targeting countries in the region, Hungary and Romania use the FX swap as a monetary policy instrument with a view to supplying or absorbing the appropriate amount of liquidity, overcoming problems in the interbank swap market and supporting their overall financial stability.

Foreign capital inflow

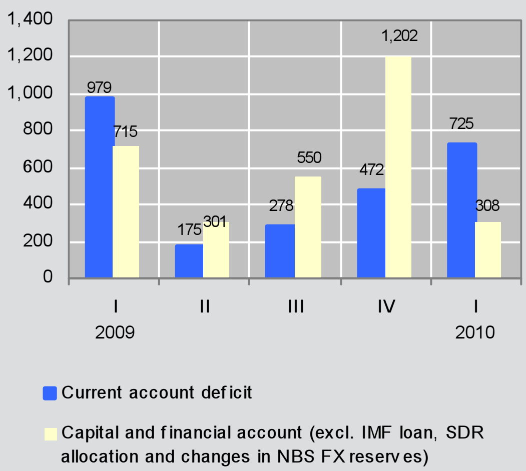
Despite solid inflows under banking sector long-term foreign borrowing in Q1, net inflow on the financial account was low as a consequence of the January repayments of short-term loans taken by banks in late 2009, and the withdrawal of deposits from banks by their parent banks.

Reduction of bank short-term foreign debt by around EUR 380 million over the first three months of the year was fully covered by net long-term borrowing in the amount of around EUR 400 million. By contrast to banks, enterprises reduced their long-term foreign debt in net terms, but on a relatively modest scale (EUR 77 million).

Net FDI inflow was comparatively low in Q1 – EUR 284 million and is mostly accounted for by the recapitalisation of Komercijalna banka a.d. (EUR 89 million) and US Steel (EUR 52 million).

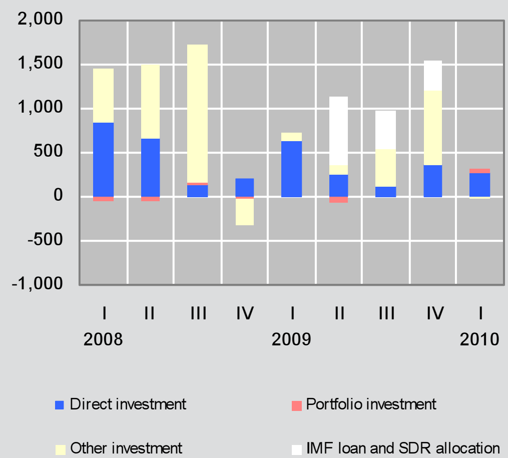
Relatively low net inflow on the financial account in Q1 against the backdrop of seasonally higher client demand for foreign exchange had a dampening influence on the foreign currency liquidity of banks.

Chart IV.2.5 **Current account deficit and net capital inflow**
(in EUR mln)



Capital inflow in Q1 did not suffice to cover the current account deficit.

Chart IV.2.6 **Structure of the financial account**
(in EUR mln)



Q1 saw a modest capital inflow.

3. Capital market developments

Capital market remained illiquid and BSE market capitalisation contracted in Q1. However, Belex 15 picked up slightly, while BELEXline weakened.

A mild recovery in Belgrade Stock Exchange (BSE) indices Belex 15 and BELEXline, in place since early 2010, came to a halt in March. At end-March, Belex 15 was worth 685.7 index points, up by 3.3% from Q4. BELEXline experienced a rather substantial fall in March – it came to 1,307.3 index points at end-March, down by 0.3% relative to December. In early April, the value of BSE indices spiked only to decline again by end of the month – Belex 15 and BELEXline rose by 9.3% and 8.5% in April respectively.

Exceptionally low liquidity of the domestic capital market, evident since the outbreak of the crisis, continued into 2010 as well. Total trading volume in the first four months came to mere RSD 6.5 billion.

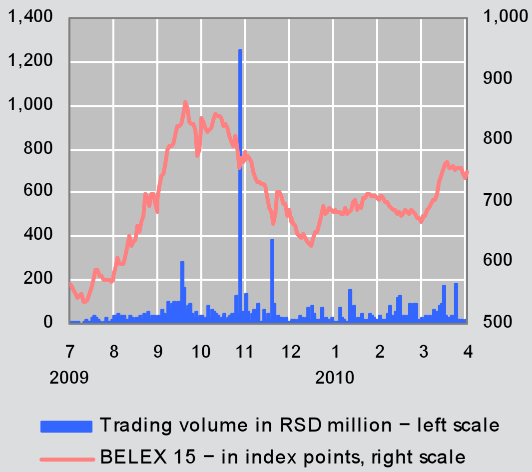
In the year to April, net purchase of shares by foreign investors was RSD 1.7 billion. This, however, did not impact on the value of indices, mainly due to profound disturbances on the side of domestic investment demand.

The rates of return for all maturities of frozen foreign currency savings bonds tumbled down, save for bonds maturing by end-May 2010. Bond trading in Q1 contracted as well – by 10.3% to RSD 758 million, whereas the trading in April reached RSD 206.6 million. Bond A2013 series were the most frequently traded in, accounting for 25.4% of total turnover.

Overall BSE market capitalisation narrowed by RSD 44.3 billion, equalling RSD 888 billion by end-April. With no significant reduction in the shares value and the neutralising effect of currency depreciation on the decline in value of frozen foreign currency savings bonds, reduced market capitalisation may be correlated with negative trends in the real sector. As a number of enterprises went into bankruptcy proceedings in Q1, their shares were automatically delisted from the BSE.

Stagnation in place since early 2010 was manifest on the majority of stock exchanges in the region. The Banjaluka stock exchange index (BIRS) performed the worst, and Sofia and Ljubljana stock exchanges fared badly as well.

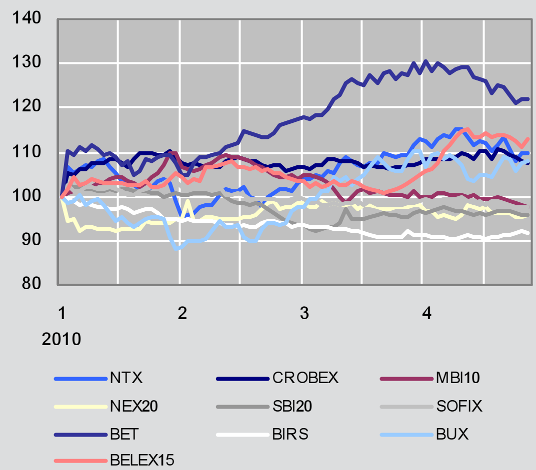
Chart IV.3.1 **Belex 15**



Source: BSE.

BELEX15 recorded negligible growth in Q1, while trading in the shares listed on it dipped further down.

Chart IV.3.2 **Stock exchange indices across the region**
(in index points, normalised, 31. 12. 2009 = 100)



In the year to date, most of the stock exchange indices in the region stagnated.

Only the Bucharest Stock Exchange index (BET) rose by an appreciable degree – leaping at end-Q1 to its August 2008 levels.[4]

Although BELEX Sentiment has shown a strong upward trend since January 2010, as indicated by positive expectations of market participants in terms of stock exchange trends, the assumptions of recovery of the BSE seem rather far-fetched.

4. Aggregate demand

Economic activity picked up mildly in Q1 owing primarily to the increase in domestic demand and much less to rising net exports. Domestic demand increased as a result of higher public consumption.

Notable increase in public consumption and contraction of the trade deficit in Q1 provided positive contributions to GDP growth of 1.6 pp and 0.1 pp, respectively, thus managing to offset the effects of declining investment and personal consumption (-0.4 pp each). Though the contribution of net exports in Q1 was small, y-o-y they remain the key contributory factor of GDP growth.

Apart from the increase in net exports (1.7 pp), positive contribution to GDP growth (1.5%) in 2010 is expected from investment (0.9 pp) whose recovery will be led by the government capital investment.

Domestic demand

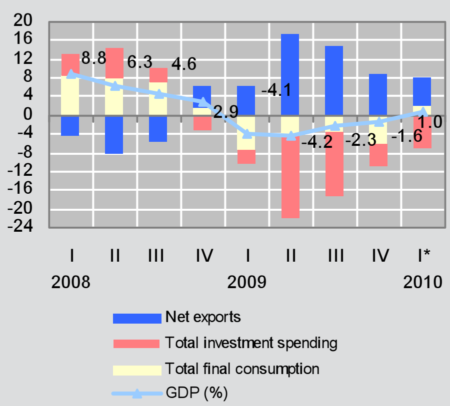
Household spending

The decline in household spending moderated in Q1 in response to a milder decrease in household income.

Seasonally-adjusted data point to a slower decline in household spending[5] (0.5%) relative to the quarter before and to its negative contribution to GDP growth in Q1 (-0.4 pp). The slowing decline in household spending is also observed y-o-y (0.4%).

In seasonally-adjusted terms, the drop in overall household income (wages, pensions and social transfers)

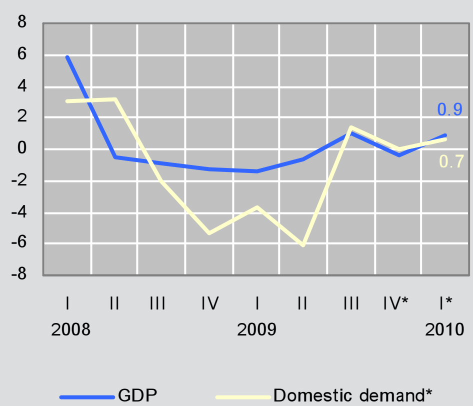
Chart IV.4.1 **Contribution to y-o-y GDP growth***
(in percentage points)



* NBS estimate.

Q1 is estimated to have seen a mild y-o-y GDP growth owing to the increase in exports of goods and services.

Chart IV.4.2 **Growth in GDP and domestic demand**
(seasonally-adjusted quarterly growth rates)



* NBS estimate.

Q1 saw moderate GDP growth, while domestic demand showed a somewhat milder increase due to investment downturn.

[4] Belex 15, together with indices of Banjaluka, Macedonia and Ljubljana stock exchanges, showed the slowest recovery during the crisis. At end-Q1, the values of these indices remained halved relative to August 2008.

[5] Including non-profit institutions providing services to households.

softened (1.3%) relative to the previous quarter. This came about primarily as a result of quarterly growth in average real net wages bouncing back particularly strongly in March. Pensions and social transfers remained broadly unchanged.

Seasonally-adjusted real net inflow of foreign exchange increased on the previous quarter (0.3%), but the volume of exchange dealers' purchases of foreign currency from households recorded a decline.

Bank lending is on the mend. It picked up in Q1 mostly owing to positive developments in March. The trend is confirmed by seasonally-adjusted data as well.

At the same time, household savings rose by 2.9% on the quarter earlier.

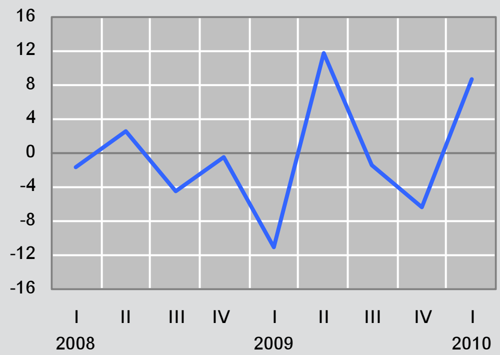
A milder decline in household spending is also signalled by the slower drop in retail trade turnover which measures 2.2% seasonally-adjusted. The decrease in the green markets turnover was contained at the previous quarter's level (3.9%).

Household spending is expected to continue recovering, ending the year with a much softer decline than in 2009.

Public spending

Government spending experienced a hefty rise in both y-o-y and seasonally-adjusted terms relative to Q4. This shift however is only temporary.

Chart IV.4.3 **Public expenditure**
(seasonally-adjusted data, quarterly growth, in %)



Public consumption went up Q1 as a result of increased spending on the purchase of goods and services.

Outlays for the purchase of goods and services and public sector wages in Q1 showed an increase in government spending from a quarter earlier by 11.7% in real y-o-y terms. Excluding the seasonal effect, government spending increased by 8.7% relative to Q4. Public spending contributed 1.6 pp to GDP growth.

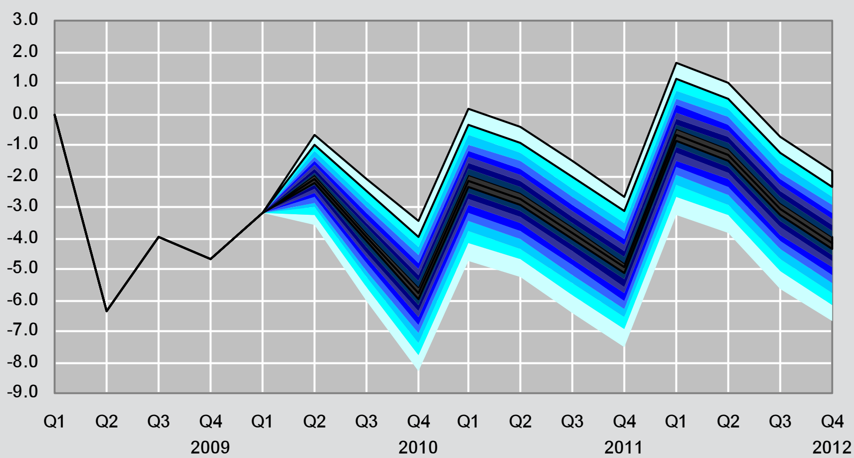
Given the freeze on public sector wages introduced in 2009, growth in government spending was prompted by a substantial rise in purchases of goods and services. As the 2010 budget envisages a nominal increase in the value of purchases of goods and services of ca 10%, their real growth in the coming period is likely to be much lower.

Text box 3: Future path of fiscal policy

The budget deficit reached RSD 21.8 billion in Q1 (of the RSD 120 billion expected at annual level) and had a monetary effect of RSD 10.1 billion. However, the fiscal policy effect on demand in 2010 could end up being smaller than forecast right after the budget law was adopted. The planned international placement of bonds will most likely be abandoned, and financing for the deficit might be pursued through a much stronger than originally expected increase in the stock of T-bills (RSD 26 billion). Hence, the 2010 deficit in the amount of around 4% of GDP would be financed primarily by drawing on domestic funds. Note, though, that 18-month bills may be purchased by foreign investors, too, which could increase the monetary effect to a degree. Let us remind ourselves that last year's deficit of RSD 120 billion had a RSD 19.3 billion effect on demand (i.e. 0.7% of GDP). Our initial estimates were that the monetary effect of the budget deficit could reach up to 2.7% of GDP in 2010, while less than 1% of GDP appears much more plausible now.

As set out in the Budget Memorandum, the deficit is expected to gradually decline over the coming two years – after 4% of GDP in 2010 (in line with the adopted budget law), the budget deficit should equal 3.5% of GDP in 2011 and 2.4% in 2012. The underlying assumption is a real GDP growth of 1.5%, 3% and 5% in 2010, 2011 and 2012, respectively, and the fiscal system reform designed to boost the revenue-generating capacity (through reform of the income tax, profit tax, VAT and excise duties, and amendments to customs regulations) and to cut public expenditure. Our estimates, however, suggest the prevalence of downward risks of divergence from the central value (deficit) i.e. they point to the rising deficit (see the chart below[1]).

Budget deficit projection
(as % of GDP)



The key risk among those likely to push the deficit above the level planned is the increase in wages and pensions. Assuming adjustment of wages and pensions by the percentage of inflation expected this year (6%), the deficit will grow by 0.38% of GDP in 2010 and by additional 1.5% of GDP in 2011 (provided that the increased wages and pensions are paid out during the last three months of 2010 only). Other risks relate to the outlook for economic growth and public revenue.

[1] The chart is based on assumptions stated by the Government of the Republic of Serbia in the Revised Memorandum on the Budget and Economic and Fiscal Policies for 2010, with Projections for 2011 and 2012.

Text box 4: Structural balance of the Serbian budget

The structural or cyclically adjusted deficit of the Serbian budget in Q1 was quite high, especially for that time of the year, making the fiscal policy countercyclical.

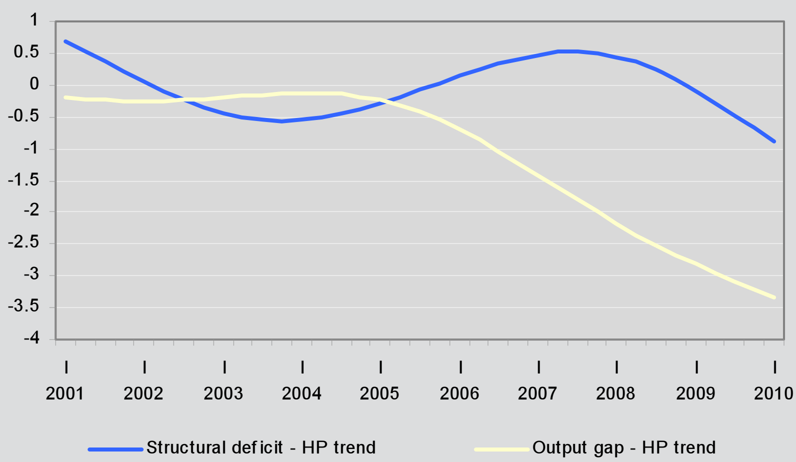
Ever since the start of 2001, the fiscal policy was markedly procyclical in periods of economic growth and insufficiently countercyclical in periods of economic slowdown.

From 2006 onwards, the structural balance was positive only in the second quarter of 2006 and 2007. Serbian budget is in a permanent structural deficit, which makes the fiscal policy procyclical during expansion and constrains its countercyclicity during recession. Namely, had there been any surplus in times of expansion, we would have had much higher deficits during recession, but as there were none, the government's options in terms of borrowing in the capital market are limited, just as the scope for its countercyclical actions.

The situation has become less unfavourable since the outbreak of the economic crisis given that the structural balance, too, has been negative in this period, and as such incipiently countercyclical. This is best illustrated by the patterns of the structural deficit and output gap when the cyclical component of the time series is separated from raw data (chart below).

	Structural budget deficit (% of GDP)	Budget balance (% of GDP)
Q1 2006	-1.4	-2.0
Q2 2006	2.9	2.9
Q3 2006	-0.2	0.1
Q4 2006	-7.8	-7.9
Q1 2007	-0.3	0.5
Q2 2007	2.0	3.0
Q3 2007	-3.0	-2.2
Q4 2007	-8.4	-7.9
Q1 2008	-1.3	1.2
Q2 2008	-4.9	-3.1
Q3 2008	-1.7	-0.7
Q4 2008	-6.6	-6.5
Q1 2009	-0.7	-1.5
Q2 2009	-5.1	-6.4
Q3 2009	-2.9	-4.0
Q4 2009	-4.0	-4.7
Q1 2010	-1.9	-3.2

HP-filtered output gap and structural deficit



Still, it seems that the shift in the character of fiscal policy is not a consequence of discretionary changes, but rather of the budget being in permanent deficit, which inevitably makes the fiscal policy countercyclical in times of economic slowdown. If the future positive cycle were to be used for the consolidation of our fiscal position, the fiscal policy could be countercyclical in all phases of the business cycle.

Investment spending

Investment spending slackened from Q4 in y-o-y and seasonally-adjusted terms.

Following an upward trend in H2 2009, investment spending plunged anew in Q1 (-1.7% q-o-q and -22.5% y-o-y), exerting the decisive impact on low growth in aggregate demand.

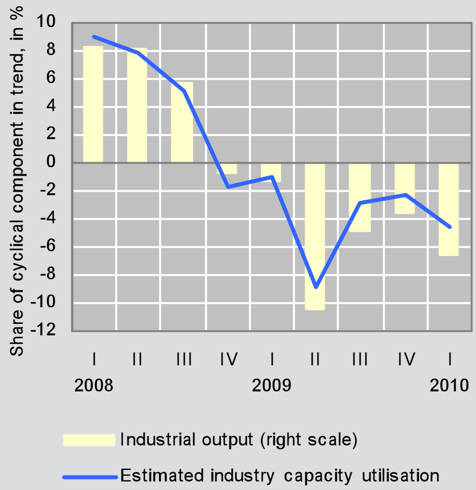
Reduction in investments weighed down on the construction industry, production and imports of capital goods. According to our estimates, the value of construction works completed continued down in real terms. Despite a slightly higher q-o-q growth in the production of capital goods, increased stockbuilding of capital goods is rather worrying.

Still far from recovery, capital investment narrowed by 14.8% relative to a quarter earlier. Production and exports of intermediate goods, however, experienced stable revival and growth.

Financial indicators are still somewhat contradictory. Despite the clear tendency of switching from foreign to domestic sources of finance (foreign investors have greater need for liquidity at home and the crisis is pushing up rates on domestic savings), the recovery of domestic lending is rather uneven. Slower growth in long-term corporate loans may be linked to weakened performance, particularly in housing construction (growth in housing loans is not a satisfactory indicator of trends in the residential construction sector as the bulk of these loans relate to real estate trading in the secondary market).

Government capital investment spending also declined appreciably (-31.8% y-o-y), in response to the markedly

Chart IV.4.4 **Industry capacity utilisation**
(seasonally-adjusted data)



Industry capacity utilisation is estimated to have declined in Q1.

Table IV.4.1 **Investment indicators**
(growth rates in %)

	Q1 2009 / Q1 2008	Q2 2009 / Q2 2008	Q3 2009 / Q3 2008	Q4 2009 / Q4 2008	Q1 2010 / Q1 2009
Real indicators					
Construction	-14.0	-16.6	-18.4	-19.6	-15.3 *
Industrial production of capital goods (physical volume)	-29.8	-22.3	-22.1	-12.9	1.8
Exports of capital goods**	-15.7	-16.9	-29.2	-19.5	-9.2
Imports of capital goods**	-19.2	-23.7	-12.8	-7.7	-15.7
Stocks of capital goods	-17.7	-20.5	-17.8	-10.5	4.4
Industrial production of intermediate goods (physical volume)	-34.7	-34.2	-18.6	3.3	11.6
Exports of intermediate goods**	-46.1	-49.2	-42.8	-3.1	37.1
Imports of intermediate goods**	-21.0	-19.5	-10.1	-0.1	10.0
Stocks of intermediate goods	0.0	-4.2	-5.3	-3.4	-1.9
Government investment spending**	25.7	-19.7	-20.4	-21.3	-31.8
	2009				2010
Financial indicators	Q1	Q2	Q3	Q4	Q1
Medium- and long-term external borrowing by enterprises (net) in EUR million	-160.2	-226.0	-114.0	-35.4	-77.0
Short-term credits to entreprises in RSD billion	55.9	2.3	8.8	-1.8	32.5
Long-term credits to enterprises in RSD billion	18.6	3.4	10.7	35.4	16.1
Long-term credits to households in RSD billion	12.7	-5.8	4.1	21.0	23.8

* NBS estimate.

** Imports are deflated by the index of producer prices of manufactured products in Germany; Exports are deflated by export producer prices of capital goods; Government investment spending is deflated by the index of producer prices of manufactured products.

slow project execution dynamics typical for early year. The coming period is likely to see faster project execution as the planned 2010 budget envisages growth in investments of at least 20%.

Industrial capacity utilisation declined from a quarter earlier as indicated by the cyclical component of labour productivity in industry.

Despite some improvement in export demand, it is investment spending that is expected to play the key role in the recovery of our economy in 2010.

Net external demand

Thanks to the growth in exports and stagnation in imports, net external demand provided a positive contribution to GDP in Q1. The rise in imported inflation, begun in the previous quarter, continued.

According to seasonally-adjusted data, exports rose on the previous quarter, while imports stagnated. As a result net export provided a modest, but positive contribution to GDP growth of 0.1 pp. The stagnation in imports is consistent with the estimated decline in investment activity and persistently low personal consumption.

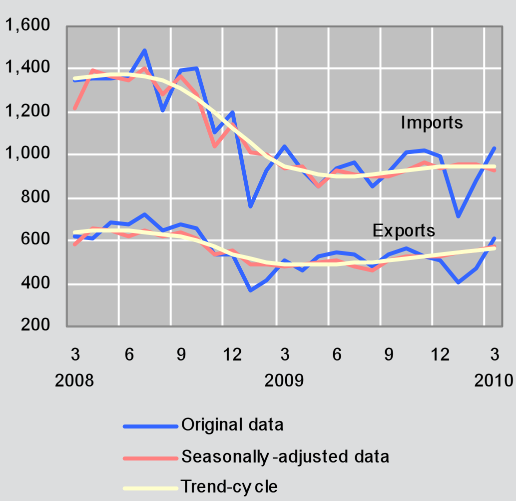
According to our estimates, net exports continue to provide the strongest contribution to GDP growth y-o-y (6.1 pp). Y-o-y data for Q1 point to an increase in exports and to a softer decrease in imports relative to the previous quarter (18.6% vs. 4.8%). Growth in the exports of goods was recorded for the first time since Q4 2008 and measured 13.9% y-o-y. In response to such movements, the trade deficit contracted by 21.4% y-o-y.

The growth in exports was driven primarily by iron, steel and non-ferrous metals, mirroring their increased production. Y-o-y imports of capital goods continue on a steep downward path, signalling lower volume of capital investment.

Encouraging as it may be, export growth is due primarily to the increase in exports to the EU. Export growth is consistent with the registered rise in industrial export prices in Q1, though it should be noted that industrial producer prices recorded somewhat stronger growth in the domestic market because of the depreciation of the dinar. Imported inflation[6] rose on the previous quarter to 20.6% at annual level as a result of depreciation of the nominal effective exchange rate of the dinar. Nevertheless, as in Q4 2009, the rise in imported inflation had no impact on core inflation which remained nil.

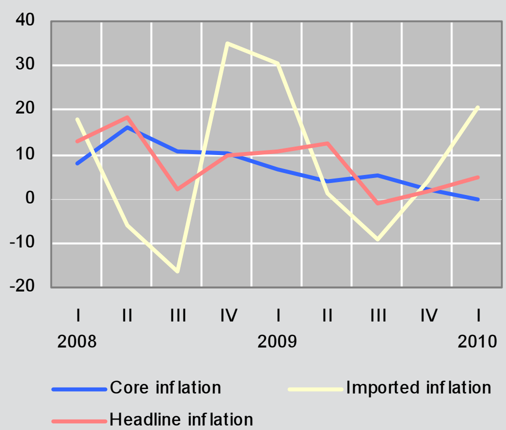
After the January fall, oil prices surged through February and March on the back of continued recovery of the global economy and healing of oil demand that had been on the decline for two consecutive years. By the end of Q1, oil prices shot past USD 80 pb as the European

Chart IV.4.5 **Exports and imports**
(in EUR mln)



Thanks to the growth in exports, the trade deficit contracted slightly from the previous quarter.

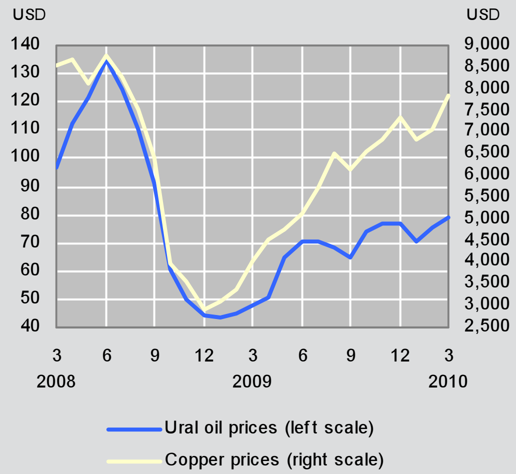
Chart IV.4.6 **Domestic and imported inflation**
(average quarterly growth rates p.a.)



Source: NBS and Eurostat.

The growth in imported inflation stepped up in Q1 as a result of depreciation of the nominal effective exchange rate.

Chart IV.4.7 **Oil and copper price movements**



Source: *Bloomberg.*

After falling in January, oil prices trended up throughout February and March. The price of copper exibited similar movements, but grew at a somewhat faster pace.

leaders clinched a deal to rescue Greece. Oil demand is expected to increase substantially this year, especially in China, India and the Middle East. Average oil price in 2010 is forecast within the range of USD 75–80 pb. If the prices go up too much, the fragile recovery of the global economy might come under threat. Still, considering that the government stimulus measures are time-limited, their withdrawal in late 2010 and early 2011 could dampen the demand for oil and send its prices down.

International prices of primary agricultural commodities (notably corn and wheat) plummeted in mid-January. Corn prices fell reflecting weaker demand, but also good condition of crops in the southern hemisphere (Brazil, South Africa) that prompted upward revision of the world corn production forecasts. After rising in the last quarter of 2009 on concerns over future output of the world's largest wheat producers (EU, USA, Russia), wheat prices headed down in early 2010 when the reports came out on the wheat-sown acreage and forecasts of favourable weather conditions. Another contributory factor to the drop in dollar prices of agricultural commodities was the strengthening of the greenback against the euro in place since the beginning of the year.

As the global economy pulls out from the crisis, the prices of primary agricultural commodities are likely to go up in response to stronger demand, coming especially from the highly-populated developing countries like India and China.

Q1 movements in prices of copper, the most important non-ferrous metal for Serbia, were similar to those of oil – they fell in January and upped in February and March, reaching at the close of the quarter almost USD 8,000 per tonne (early 2008 levels). As in a quarter earlier, copper prices were driven by buoyant demand from China, the world's largest importer, and by expectations of continued recovery of the global economy. Demand for copper is expected to strengthen further over the coming period.

5. Economic activity

Economic activity is estimated to have improved somewhat in Q1 – GDP rose by 0.9% q-o-q. For the first time since the start of the crisis, GDP grew in y-o-y terms – by 1%. Negative output gap deepened.

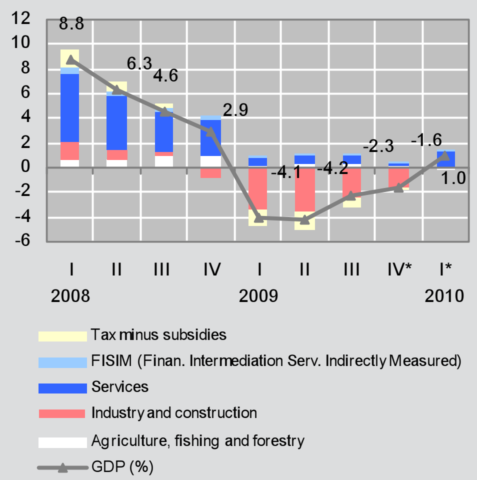
Recovery in place since Q3 2009 slowed down in Q4. Based on official statistics, economic activity declined in Q4 by 0.4% in seasonally-adjusted terms, whereas NAVA (according to our estimates and seasonally-adjusted data), saw a quarterly rise of 0.3%. Y-o-y, GDP and NAVA declined by 1.6% and 2.0% respectively, which is somewhat above our expectations. Though higher than anticipated, the estimated fall in GDP in 2009 (3%) remains appreciably lower compared to the neighbouring countries.

In seasonally-adjusted terms, Q1 saw a mild pick-up in economic activity. GDP grew by 0.9%, whereas NAVA stagnated (-0.1%).

Overall industrial output recorded quarterly growth (1.9%), mainly due to growth in mining and quarrying sectors. Manufacturing, however, saw a quarterly decline

[6] Imported inflation is a result of change in the nominal effective exchange rate of the dinar (weights: 0.8 for the euro and 0.2 for the dollar) and prices in the eurozone and the United States.

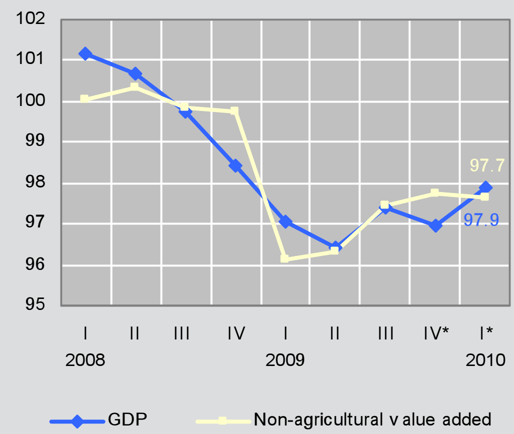
Chart IV.5.1 **Contribution to y-o-y GDP growth**
(in percentage points)



* NBS estimate.

A mild y-o-y GDP growth is expected in Q1.

Chart IV.5.2 **Growth in economic activity indicators**
(seasonally-adjusted data, 2008 = 100)



* NBS estimate.

A mild growth was recorded in almost all sectors of economic activity, which reflected on GDP movements.

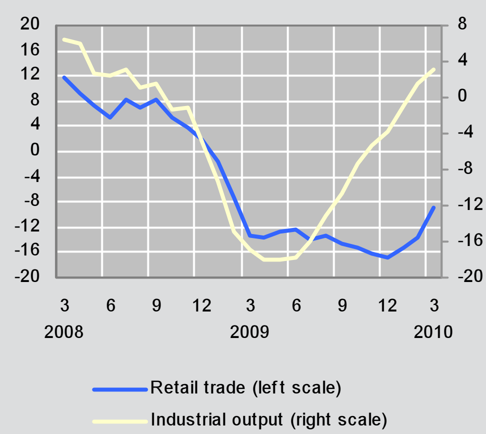
of 0.2%, most notably due to slackening production of coke and petroleum products (8.2%), rubber and plastic products (12.1%) and basic metals (13.4%). In terms of economic destination, the steepest quarterly decline was recorded with the production of capital goods (2.0%), whilst the production of consumer durables showed the sharpest rise (3.6%) relative to a quarter earlier.

Construction is estimated to have declined further in Q1 (1.7%), partly in response to reduced government investment spending.

A decline in trading volumes continued (1.6%), which can be attributed to the persistently weaker purchasing power of households.

In y-o-y terms, Q1 saw mild GDP growth (1%), mainly on account of the low 2009 base. The greatest contribution to GDP growth came from a 4.1% rise in manufacturing (contribution: 0.5 pp) which impacted on y-o-y rebound in overall industrial output (3.0%) after more than a year. The strongest impetus to y-o-y growth

Chart IV.5.3 **Quarterly moving averages of industrial output and retail trade**
(y-o-y rates, in %)



Y-o-y decline in retail trade is slowing down, while industrial output shows growth as a result of last year's low base.

in manufacturing came from the production of base metals (2.7 pp) and chemicals and chemical products (0.5 pp). The strongest negative contribution came from the production of coke, petroleum products and tobacco products. In terms of destination, industrial output revealed a mild rise in the production of capital goods, which may signal a persistently low investment activity. Still, the production of intermediate goods showed a 11.6% rise y-o-y.

Furthermore, a decline was recorded in the retail and wholesale sector (5.7% y-o-y), as well as construction (15.3% y-o-y). Construction weakened primarily due to declining production of non-metal minerals (9.4% y-o-y) and government investment spending (capital expenditure contracted by 31.8% y-o-y).

Measured by NAVA, economic activity points to deepening negative output gap. Such movements indicate further prevalence of disinflationary pressures amid persistently weak aggregate demand.

6. Labour market developments

Wages

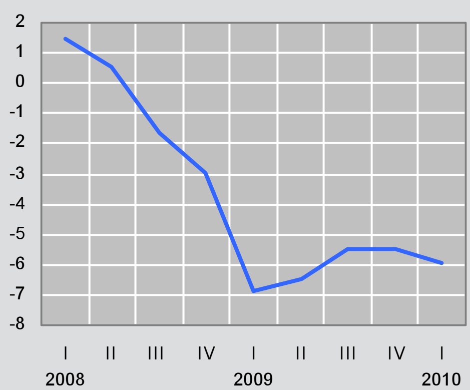
Aggregate wages increased in both real and nominal terms relative to a quarter earlier. Wage growth in the public sector was lower than in the private sector.

Aggregate wages increased in Q1 on a quarter earlier. In seasonally-adjusted terms, they rose by 3.5% in nominal terms and for the first time after a year, recorded real growth as well – 2.8%.

In terms of original series of data, average net wage came to EUR 321, down by 8.7% q-o-q, mainly in response to high seasonal growth in nominal wages in the previous quarter.

Seasonally-adjusted data signal growth in wages in all activities other than in the financial and agricultural sectors that suffered a downturn relative to Q4. The trade

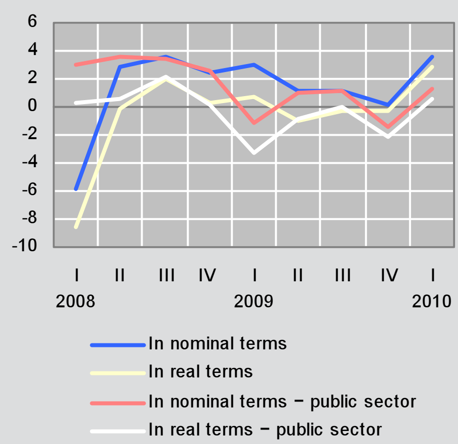
Chart IV.5.4 **Output gap***
(percentual deviation from the trend)



* NBS estimate.

Though economic activity picked up midly in Q1, negative output gap deepened further.

Chart IV.6.1 **Average net wages - total and the public sector**
(seasonally-adjusted data, quarterly growth, in %)



Real public sector wages rose at a much slower pace than total wages.

sector saw the sharpest wage growth, followed by construction and real estate sectors.

Public sector wages experienced perceptibly lower both nominal and real growth (1.3% and 0.6% respectively).

Judging by seasonally-adjusted data, growth in gross real wages in the industrial sector and contraction in productivity resulted in a moderate q-o-q rise in unit labour costs. A pick-up in unit labour costs in manufacturing was slightly above the average for the total industry owing to a larger fall in manufacturing output.

The q-o-q wage growth gave rise to a slowdown in the quarterly decline in household spending.

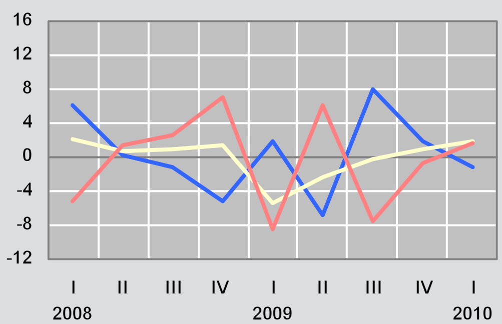
Employment

The rise in unemployment and decline in formal employment continued in Q1.

Labour market conditions in Q1 worsened still. According to the results of the LABOUR survey carried out by the Statistical Office, formal employment dipped further down primarily as a result of decline in the number of persons employed by legal entities.

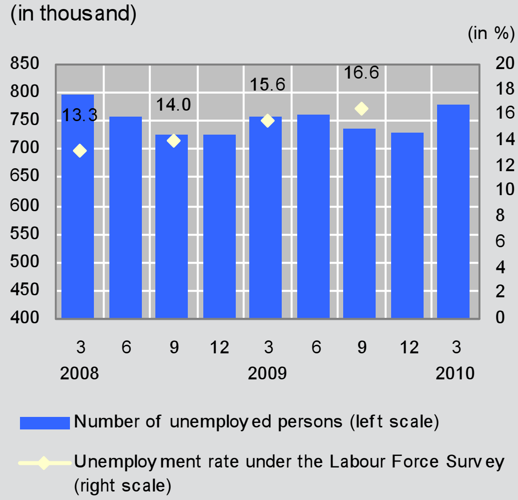
Broken down by sector, the decrease in legal entities' employment was the sharpest in the manufacturing industry, construction, and transport, warehousing and communications. Employment rose in the real estate and trade sectors. In terms of the public sector, employment growth was registered only in the sector of education, while other sectors showed a decline, the steepest being in the sector of utility services. A mild drop in employment was also observed with local public enterprises.

Chart IV.6.2 **Movements in productivity, real gross wages and unit labour costs in the industry**
(seasonally-adjusted data, quarterly growth, in %)



Higher real gross wages and lower productivity triggered a rise in unit labour costs in the industrial sector.

Chart IV.6.3 **Unemployment**
(in thousand)



Source: National Employment Service and Serbian Statistical Office.

Unemployment continued rising in Q1.

Once they become available, the results of the Labour Force Survey will give us a more complete picture of the number of persons employed.

The jobless numbers rose in January and February. As indicated by the National Employment Service records, unemployment rose by 5.1% in February relative to end-2009, reaching 767 thousand, which is close to the level recorded in the first half of 2008.

Deterioration in the labour market conditions was moderated to a degree by the apprentice employment schemes and public works programmes that are likely to be implemented in 2010 as well.

According to the National Employment Service records, the newly registered employment increased in February by 8.5% relative to end-2009, while the number of first-time job seekers edged up by 4.1%.

7. International environment

The post crisis recovery of the global economy has been erratic in terms of its regional distribution. Measures to encourage demand will most probably be abandoned sometime in the course of the year, but the monetary policy will continue to be expansionary. Economic growth of the Serbian major trading partners remains on the weak side.

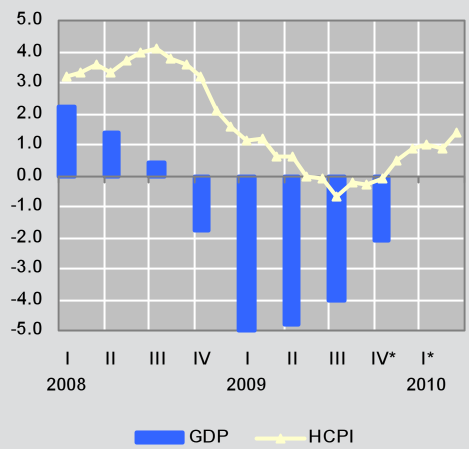
Apart from the fiscal problems experienced by some peripheral eurozone member countries and investor concerns that the "Greek scenario" might happen in some other countries as well, economic news is mostly positive. It is expected that the economic revival begun in the H2 2009 will continue into Q1 2010 though remaining unevenly distributed across the globe. A strong growth is expected in China and in other Asian emerging markets, moderate growth on the North American continent and, despite notable weakening of the euro, a very weak growth in the euro zone.

The world has dodged the depression bullet by successfully implementing extraordinary economic policy measures in the course of the last 18 months. A series of coordinated steps have been taken by governments and central banks, from bailing out banks on the verge of collapse to implementing ultra expansionary monetary policies. The key obstacle now lies in the need to withdraw most of the demand-support measures in the course of 2010, though some European countries are facing painful budgetary cuts and could use any measure of financial support to sustain economic growth. The dynamics of the exit strategy will be the most delicate challenge facing the developed economies in 2010 as even countries which currently boast comfortable public finance position owe their recovery to those very same support measures.

Though US economy has displayed great flexibility in the current crisis, the sustainability of its recovery could be brought into question once unconventional monetary policy measures are withdrawn and the effects of stimulating government packages are exhausted. Fed is therefore expected to keep its policy rate at the current level throughout 2010. High unemployment rates, tighter credit conditions and losses related to the downfall in property prices and shares are likely to induce a decline in household spending. Still, a 3.1% GDP growth of the US economy in 2010 is much above that expected in other developed regions.

Economic recovery in the eurozone, a region with which Serbia trades most, is expected to be weak in 2010 and burdened with numerous difficulties. Banks are still facing risks related to bad debts and large exposure to East European countries. There was great uncertainty

Chart IV.7.1 **Euro zone GDP and inflation**
(y-o-y growth rates)



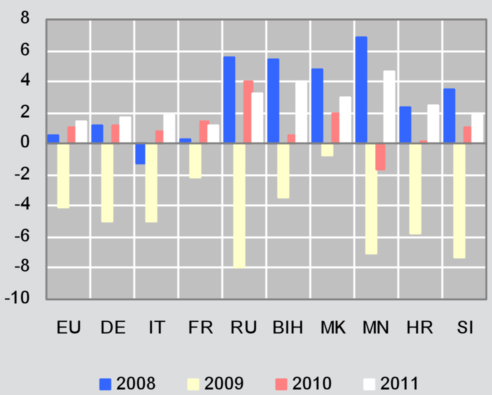
* Estimate.
Source: EUROSTAT.

Inflation growth, begun a quarter earlier, stepped up in Q1 2010 on the back of rising oil prices. Economic downturn is estimated to have slowed down further in Q1.

over the Greek bailout package in the last two months as the euro zone members could not agree on the terms of their support. Their recent agreement has only temporarily removed the uncertainty, but d doubts remain as to whether Greece will be able to timely service its debts in the long run. At the same time, the Greek debt crisis has brought disquiet over creditworthiness of some other euro zone members and of the overall stability of the euro zone itself. This region is expected to grow by 1% only in 2010 and not much improvement in that respect is expected in 2011 either. To sustain the expected slow recovery in the euro zone, the European Central Bank will not be increasing its policy rate during 2010 but, similar to Fed, will gradually withdraw the unconventional monetary policy measures in place in the prior period.

Emerging markets are recovering much faster than most of the developed countries. Led by China, Asian countries are the current leaders of global economic recovery. This is in part due to the generous stimulus programs delivered by their governments, but primarily to the fact that their economies were in a relatively good condition when the crisis hit globally. The only exception is Japan whose economy is suffering under renewed deflationary pressures which discourage spending and investment as well as fresh borrowing.

Chart IV.7.2 **Serbia's key foreign trade partners - GDP growth rates and their projections**
(in %)



Source: IMF, WEO, April 2010.

Though the above economies are expected to recover mildly in 2010, this will not be enough to ensure any major growth in Serbian exports.

Contrary to the Asian region, East European economies are recovering slowly, but the business climate and consumer sentiment are still rather low. The global financial crisis has left an indelible mark on the East European economies and curtailed their development potentials. Foreign direct investments have declined substantially and the trouble is likely with respect to budget deficit financing. The region is expected to grow by only 2.8% in 2010 and by 3.4% in 2011. In view of that, the regional central banks are likely to continue implementing expansionary monetary policy. As room for further cutting back of their policy rates became evident, central banks of the countries whose economies showed no signs of recovery (Hungary, Romania) lowered their policy rates in Q1. Policy rates of central banks in the region are likely to retain their current level or even to decline somewhat during the coming period. Monetary policy implemented in East European countries is flexible and designed to encourage economic growth. Hence, the central banks of these countries will probably be making their best efforts to delay by as much as possible any increases in their policy rates.

Movements in exchange rates over the several recent months were largely affected by uncertainties regarding public debt sustainability in the peripheral eurozone countries. The exchange rate for the euro declined against the dollar primarily as a consequence of the possible spreading out of the Greek debt crisis to other countries of the eurozone that are releasing weak public finance figures. From November 2009 to end-Q1 2010, the euro weakened against the dollar by 8%. The prospect of defaulting on debt repayment could continue creating instability in the forex markets in the period ahead. A notable difference between rates of growth in the USA and those in the eurozone in Q4 2009 that will most probably continue into Q1 2010 will also play a role in future exchange rate movements. A significant impact may also come from the lack of trust on the part of market participants in the implementation of Greek austerity measures and the spill-over effect of the Greek crisis on other members of the eurozone.

V. Inflation projection

After undershooting its lower bound in H1, inflation is expected to gradually retreat within the target tolerance band in H2 under the impact of the past depreciation of the dinar and the halted decline in food prices. At the same time, low aggregate demand, sustained by the freeze on public sector wages and pensions, will act as a damper on any major inflation growth. In view of the recovery in foreign demand and the past real depreciation of the dinar, economic activity is expected to grow moderately. Though there is still room for monetary easing, the key policy rate will be lowered at a slower pace than before.

The medium-term inflation projection aims to show 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 presumes 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.

Background information

Inflation moved below the lower bound of the target tolerance band in Q1 2010. Quarterly consumer price growth was entirely due to the growth in regulated prices (notably, electricity and cigarette prices) and a seasonally-induced increase in agricultural product prices.

Market-determined prices, by contrast, stagnated. Zero core inflation in Q1 is a result of divergent movements of its two components. Namely, while the decline in food prices accelerated contrary to our expectations, non-food core inflation turned out higher than a quarter earlier. Higher non-food core inflation is partly attributable to the rise in import prices occasioned by the dinar's depreciation in late 2009 and early 2010. Any way, the exchange rate pass through to prices was perceptibly low against the background of dampened aggregate demand.

Faster growth in import relative to domestic prices sent importers' net profit margins down, thereby inducing a widening of the depreciation gap. Importers' attempts to increase their net profit margins could develop into the key inflationary factor in the medium term.

Low aggregate demand, sustained by the freeze on public sector wages and pensions will be working in the opposite direction as the key disinflationary factor in the medium

Table V.0.1 **Projection assumptions for 2010 and 2011**

	2010	2011
External assumptions		
EU inflation (Q4 to Q4)	1.2%	1.5%
ECB policy rate (year-end)	1%	2%
Euro area GDP growth	1.2%	1.5%
Ural oil price per barrel (year-end, USD)	86	95
Internal assumptions		
Regulated prices excl. petroleum products (Dec to Dec)	9.3%	8.0%
Prices of agricultural products (Dec to Dec)	8.0%	8.0%
Trends		
Appreciation trend of the real exchange rate (average)	2.4%	2.9%
Real interest rate trend (average)	4.2%	3.9%

term. Output gap, as the demand-side measure, widened further in Q1 and was even deeper in the negative zone than a quarter earlier.

After stagnating in Q4 2009, economic activity recorded mild growth in Q1. Getting out of recession, however, will not be as swift as we had hoped for. The pace of recovery will largely depend on developments in the EU, our key trading partner. Though positive growth rates were registered in the EU for the third quarter in a row (preliminary data), its overall recovery will be modest.

The widening of the depreciation gap in Q1 conditioned a more expansionary monetary policy than in the quarter before. At the same time, real two-week interest rate in the interbank market worked in the opposite direction: it edged up on the back of lower inflation expectations despite the March cut in the key policy rate from 9.5% to 9%.

Assessing disinflationary pressures as prevalent, the NBS Monetary Policy Committee lowered the key policy rate further in April and May – from 9.0% to 8.0%.

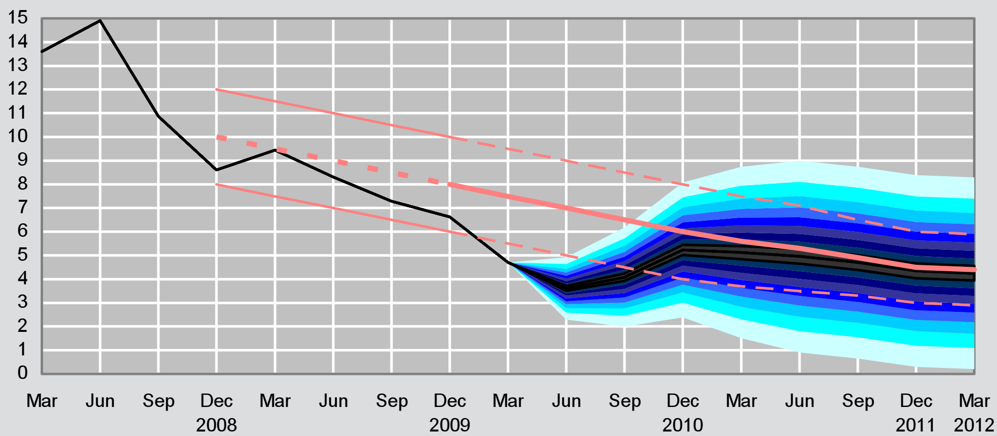
Projection assumptions

In view of their growth since the beginning of the year and announcements of future adjustments, regulated prices are expected to remain within the planned growth range of 9±2%. The projection assumes that the government will adhere to its plan for regulated price growth in 2011 as well (7±2%).

As the agricultural product prices are currently very low, they are likely to grow faster than other prices over the next two years.

Despite recent weakening of the dinar, we believe there are no fundamental reasons to expect depreciation trend of the real exchange rate to continue in the medium term. Quite to the contrary, with the waning of the crisis, the trend of price convergence to the eurozone (real appreciation of the dinar against the euro) is expected to step up again. Together with the decline in risk premium, this should induce a drop in the real interest rate trend.

Chart V.0.1 **Inflation projection**
(y-o-y rates, in %)



After undershooting its lower bound in H1, inflation is expected to gradually retreat within the target tolerance band in H2, and stay there throughout 2011.

The fan chart depicts probability of various inflation outcomes in the next eight quarters. Central projection is within the darkest central band and the probability that inflation would lie in it is 10%. Outturns of inflation are also expected to lie somewhere within the entire fan chart with probability of 90%. In other words, the probability that inflation in the next eight quarters would lie somewhere outside the band in the chart is 10%.

In terms of external factors, the projection assumes a mild economic recovery and higher inflation in the eurozone in the coming period, which would create conditions for the ECB to raise its policy rate, but not before 2011. In line with the general outlook for the global economy and demand, international oil prices are projected to grow at a moderate pace.

Inflation projection

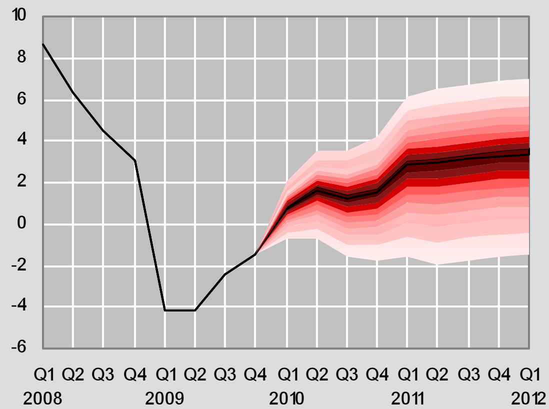
After undershooting its lower bound in H1, inflation will gradually retreat within the target tolerance band during H2, and remain there throughout 2011.

Q2 consumer price growth is likely to stay within the region recorded in Q1. However, it will be lower than in the same period a year earlier, causing year-on-year inflation rates to slip farther away from the lower bound of the target tolerance band. Q2 consumer price growth will be almost equally due to the seasonal increase in agricultural product prices, growth in market-based prices and revision of regulated prices.

By contrast to the prior period, processed food prices are expected no longer to produce disinflationary pressures from Q2 onwards. Instead, they will become the key short-term factor of core inflation growth. Some price increases in the near term, though only moderate in view of the depressed aggregate demand, can also be expected on account of the depreciation of the dinar, i.e. past growth in imported inflation. Q2 is likely to see some cost push inflation stemming from the rise in energy prices and the introduction of ecological taxation on technical goods.

In the medium run, the drop in net profit margins of importers' (manufacturers and traders), i.e. widening of the depreciation gap in late 2009 and early 2010, could be the most important factor affecting inflation. These enterprises might try to compensate for the loss in their profit margins either by raising the prices of their products once the conditions are created, or by not lowering them proportionately to the strengthening of the dinar in case such strengthening takes place some time in the future.

Chart V.0.2 **GDP growth projection**
(y-o-y rates, in %)



GDP growth in 2010 is projected at a modest 1.5%. Stronger economic growth cannot be expected before 2011 (around 3.0%).

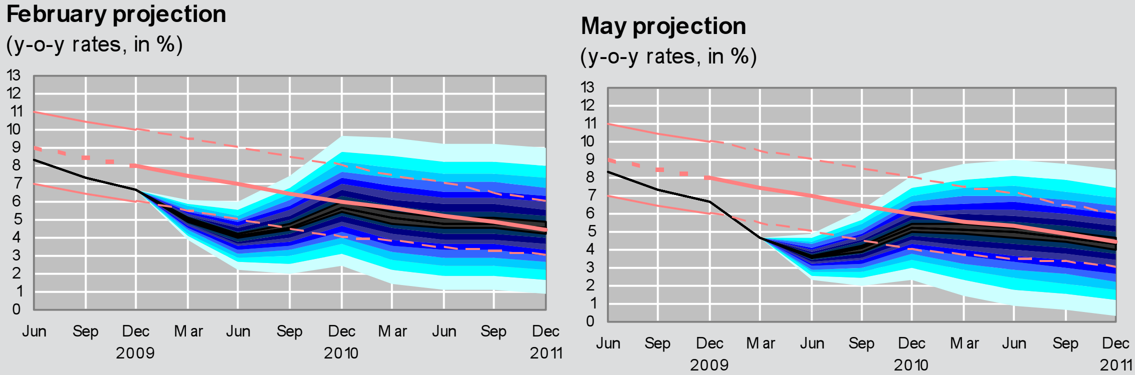
Nevertheless, no major growth in prices is likely in the current environment of weak demand. Though negative output gap (indicator of low demand) will gradually narrow as a result of the past real depreciation of the dinar and the global economic recovery, strong demand-side disinflationary pressures are likely to prevail again in 2010. They will be largely underpinned by the freeze on public sector wages (until end-2010) and pensions (until April 2011).

The two medium-term factors working in opposite directions, depressed aggregate demand and depreciation gap, aided by the halted decline in food prices, will be critical in keeping inflation on target in the medium run.

Movements in the year-on-year inflation rates in the course of 2010 will also be largely determined by the base, i.e. monthly inflation rates from the same period a year earlier[7]. Thus, the high base will cause a decline in year-on-year inflation rate in Q2, while the low base will cause its rise in H2 and steadily steer it within the target tolerance band.

[7] Year-on-year inflation in a month is on the decline if the monthly inflation rate for that particular month is lower than the corresponding rate in the same month a year earlier .

Chart V.0.3 **Current vs. previous projection**

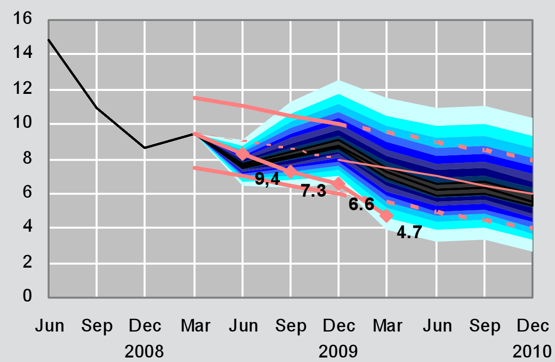


The May inflation projection for 2010 is slightly lower than the one published in the February Report, while projections for 2011 are more or less the same. The risks to the current projection are more balanced, and the projection band less tilted to the upside owing to the downward revision of inflationary risks from food prices.

Economic activity is poised for moderate growth. The healing of the economies of our key trading partners (eurozone and CEFTA members) could lead to a rise in Serbian exports given that the dinar depreciated most against the currencies of these countries. Besides, depreciation of the dinar, i.e. increase in the prices of imported goods, will encourage the substitution of imports with domestic (less expensive) products. Nonetheless, GDP growth will be modest this year (around 1.5%) reflecting the global economy's sluggish emergence from recession and the weakness of domestic demand. No major step-up in economic growth is likely before 2011 (3.0%).

The current projection is consistent with moderate lowering of the key policy rate over the near future.

Chart V.0.4 **Inflation outturn vs. May 2009 inflation projection**
(y-o-y rates, in %)



In the last year inflation moved within the band projected in May 2009, but mostly below the central projection.

Risks to the projection

The key risks to inflation projection are those relating to food prices, risk premium, exchange rate pass through to prices, and the speed of economic recovery.

With a 38% share in the consumer price index, food prices have a large impact on movements in headline inflation. From mid-2008 onwards their impact was distinctly disinflationary as a result of the two successive good harvests, decline in international agricultural product prices and the consequent decline in domestic processed food prices. Though food prices are currently rather low, there is a risk that their trend will reverse and that they will start generating inflationary pressures amid potentially weaker agricultural performance this year and/or surge in international agricultural product prices.

Though movements of the risk premium stabilised in the prior period, financial markets remain vulnerable and any major shock (such as, for instance, the Greek debt crisis)

may, contrary to our projection assumptions, push the risk premium up. This would put depreciation pressures on the dinar (i.e. import prices would rise) and induce an increase in interest rates, affecting overall inflation developments in the period ahead.

Short-term uncertainties are also associated with the extent to which net importers will be able to pass through their increased costs to end consumers against the backdrop of low demand. The risks to the projection are further embodied in the exchange rate pass through to prices in the medium term. Namely, the extent to which net importers' will respond to potential strengthening of the dinar by lowering their prices or by increasing their profit margins (e.g. keeping their prices unchanged) remains highly uncertain.

Considerable degree of uncertainty is also associated with the pace of global economic recovery that will determine in large part the strength of demand-side (dis)inflationary pressures. A faster economic rebound would lessen the demand-side disinflationary pressures, while a slower recovery would lead to their strengthening (relative to those assumed by the projection), which would produce implications not only in terms of inflation movements, but also in terms of the monetary policy outlook.

Comparison with the previous projection

The current inflation projection for 2010 is slightly lower than the one published in the February Report, while projections for 2011 are more or less the same.

Somewhat stronger demand-side disinflationary pressures and a sharper drop in food prices in Q1 are the most important reasons calling for a slightly lower current projection for 2010 than the previous one. On the other hand, the difference is offset to a degree by the somewhat looser monetary policy than assumed by the February projection, wherefore inflation rates in the coming year are approximately the same under both projections.

The risks to the current projection, however, are more balanced, and the projection band less tilted to the upside owing to the downward revision of inflationary risks from food prices.

During the last year inflation moved within the band projected in May 2009. From September 2009, however, inflation outturns were below the central projection rate, reflecting a much sharper than seasonally expected drop in agricultural product prices in H2 2009 and the consequent downfall in the prices of processed food.

Outlook for the key policy rate

Based on the current inflation projection and its underlying risk factors, the NBS Monetary Policy Committee judges that the key policy rate is more likely to be lowered in the coming period than kept on hold (8.0%).

Conditioned on the projection assumptions described above and in light of low aggregate demand and a freeze on public sector wages and pensions, the MPC judges that there is scope for further monetary easing.

The lowering of the key policy rate, however, will be slower than in the prior period. Furthermore, should inflationary pressures stemming from food prices, risk premium, exchange rate pass through to prices or aggregate demand prove stronger than anticipated, the process of monetary easing may even be halted altogether.

The National Bank of Serbia will therefore continue to monitor movements in the relevant inflation factors and act promptly in order to keep inflation within the target tolerance band.

Table A
Indicators of Serbia's external position

	2001	2002	2003	2004	2005	2006	2007	2008	2009	Q1 2010
EXTERNAL LIQUIDITY INDICATORS (in %)										
Forex reserves/imports of goods and services (in months)	3.2	4.1	4.7	3.9	6.2	9.0	7.4	5.5	9.6	9.9
Forex reserves/short-term debt	114.0	223.5	336.3	425.0	385.9	717.3	729.8	336.4	464.5	475.5
Forex reserves /GDP	10.3	13.6	16.4	16.4	24.3	38.7	33.5	24.4	34.9	34.2
Debt repayment/GDP	0.8	1.4	2.0	3.9	4.7	7.0	10.0	10.3	10.9	12.5
Debt repayment/exports of goods and services	3.8	7.0	9.0	16.5	17.7	23.5	33.9	34.0	39.1	42.8
EXTERNAL SOLVENCY INDICATORS (in %)										
External debt/GDP	98.3	67.2	62.7	54.4	64.3	63.9	61.8	65.2	75.0	76,2
Short-term debt/GDP	9.1	6.1	4.9	3.9	6.3	5.4	4.6	7.3	7.5	7,2
External debt/exports of goods and services	468.2	344.6	282.2	231.4	245.1	214.2	204.8	214.6	268.8	270,015.1
FINANCIAL RISK EXPOSURE INDICATORS (in %)										
Forex reserves/M1	135.9	143.3	195.3	221.0	291.1	356.5	306.9	300.3	393.4	463.2
Forex reserves/reserve money	136.3	132.0	168.0	166.2	170.3	177.8	173.9	140.6	190.4	201.7
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	60.2	59.3	63.9	73.7	73.6	81.2	84.3	83.9	71.5	75.5
MEMORANDUM: (in EUR million)										
GDP (in EUR million)	12,821	16,028	17,306	19,026	20,306	23,305	28,785	33,418	30,385	6,885
External debt	12,609	10,768	10,857	10,355	13,064	14,884	17,789	21,800	22,787	23,278
External debt servicing	102	218	348	736	945	1,635	2,885	3,453	3,314	859
Central bank foreign exchange reserves	1,325	2,186	2,840	3,117	4,935	9,025	9,641	8,160	10,602	10,444
Short-term debt	1,163	978	844	733	1,279	1,258	1,321	2,426	2,282	2,197
Current account balance	282	-671	-1,347	-2,620	-1,778	-2,356	-4,615	-6,089	-1,743	-725
				Nov 2004	July 2005	Feb 2006	June 2007	March 2008	Dec 2009	
CREDIT RATING				Standard & Poor's: B+	Standard & Poor's and Fitch: BB-	Standard & Poor's: BB-/positive; Fitch: BB-/stable	Standard & Poor's: BB-/stable; Fitch: BB-/stable	Standard & Poor's and Fitch: BB-/negative	Standard & Poor's & Fitch: BB-/stable	

Methodological notes:

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

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

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

Debt repayment/GDP (in %) - ratio of debt repayment to GDP during period under review.

Debt repayment/exports (in %) - ratio of debt repayment to exports of goods and services during period under review.

Debt/GDP (in %) - ratio of outstanding debt at end-period to GDP.

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

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

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

Notes:

1. Data are subject to corrections in line with the official data sources.
2. As of October 2006, the IMF publication "International Financial Statistics" features a page on monetary statistics of the Republic of Serbia. This required the NBS to bring its statistical reports in compliance with international statistical standards and methodology harmonised, at the level of the IMF, for all countries. We have adjusted our financial risk exposure indicators accordingly.
3. Trade with Montenegro is registered within relevant transactions as of 2003.
4. Foreign debt repayment does not include early debt repayment.
5. GDP for 2010 as estimated by the National Bank of Serbia.
6. In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.

Table B
Key macroeconomic indicators

	2001	2002	2003	2004	2005	2006	2007	2008	2009	Q1 2010
Real GDP growth (in %)	5.6	3.9	2.4	8.3	5.6	5.2	6.9	5.5	-3.0	1.0[1)]
Consumer prices (in %, relative to the same month a year earlier)[2)]	40.7	14.8	7.8	13.7	17.7	6.6	11.0	8.6	6.6	4.7
Core inflation (in %, relative to the same month a year earlier)[2)]	20.5	4.4	6.1	11.0	14.5	5.9	7.9	10.3	4.1	2.3
NBS foreign exchange reserves (in EUR million)	1,325	2,186	2,840	3,117	4,935	9,025	9,641	8,160	10,602	10,444
Exports (in EUR million)[3)]	2,693	3,125	3,847	4,475	5,330	6,949	8,686	10,157	8,478	2,007
- growth rate in % compared to a year earlier	20.7	16.0	23.1	16.3	19.1	30.4	25.0	16.9	-16.5	8.0
Imports (in EUR million)[3)]	-5,023	-6,387	-7,206	-9,543	-9,613	-11,971	-15,578	-17,878	-13,237	-3,177
- growth rate in % compared to a year earlier	32.3	27.2	12.8	32.4	0.7	24.5	30.1	14.8	-26.0	-5.5
Current account balance[4)]										
(in EUR million)	282	-671	-1,347	-2,620	-1,778	-2,356	-4,615	-6,089	-1,743	-725
as % of GDP	2.2	-4.2	-7.8	-13.8	-8.8	-10.1	-16.0	-18.2	-5.7	-10.5
Unemployment according to the Survey (in %)[5)]	12.2	13.3	14.6	18.5	20.8	20.9	18.1	13.6	16.1	/
Wages (average for the period, in EUR)	89.9	151.1	176.9	194.6	210.4	259.5	347.6	358.4	337.9	321.5
RS budget deficit/surplus (in % of GDP)[6)]	-0.2	-4.3	-2.6	-0.3	0.3	-1.9	-1.7	-1.8	-3.4	-3.1
Consolidated fiscal result (in % of GDP)	-0.2	-1.8	-2.5	0.8	0.9	-1.9	-2.1	-2.0	-4.0	-3.2
RS public debt (external + internal, in % of GDP)[6)]	104.8	71.9	63.7	50.9	50.6	40.1	31.4	26.3	32.4	33.6
RSD/USD exchange rate (average, in the period)	66.71	64.70	57.56	58.44	66.90	67.01	58.39	55.76	67.47	71.38
RSD/USD exchange rate (end of period)	67.67	58.98	54.64	57.94	72.22	59.98	53.73	62.90	66.73	74.38
RSD/EUR exchange rate (average, in the period)	59.78	60.66	65.13	72.70	83.00	84.10	79.96	81.44	93.95	98.67
RSD/EUR exchange rate (end of period)	59.71	61.52	68.31	78.89	85.50	79.00	79.24	88.60	95.89	99.76
Memorandum										
GDP (in EUR million)[7)]	12,821	16,028	17,306	19,026	20,306	23,305	28,785	33,418	30,385[1)]	6,885[1)]

1) NBS estimate.
2) Retail prices until 2006.
3) Trade with Montenegro is registered within relevant transactions as of 2003.
4) In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.
5) Source: Labour Force Survey, Statistical Office.
6) Source: RS Ministry of Finance Bulletin.
Note: Data are subject to corrections in line with the official data sources.

Table C
IMF's projection for key macroeconomic indicators (April 2010)

	2007	2008	2009 (Estimation)	2010 (Prognosis)	2011 (Projection)
Output, prices and labor market (change in percent)					
Real GDP growth	6.9	5.5	-2.9	2.0	3.0
Real GDP growth excluding agricultural sector	8.8	5.2	-3.4	2.0	3.1
Real domestic demand (absorption)	11.5	6.3	-7.4	0.4	2.3
Consumer prices (average)	6,5	12.4	8.1	4.8	4.8
Consumer prices (end of period)	11,0	8.6	6.6	6.0	4.5
Nominal gross wage	21.9	17.8	4.1	4.8	6.7
Real net wage	19,9	4.9	-3.7	0.0	1.8
General government finance (in percent of GDP)					
Revenue	42,4	41,4	39,6	38,4	38
Expenditure	44,2	44	43,7	42,5	41
Fiscal balance	-1,9	-2,6	-4,2	-4,1	-3
Public debt	34,3	33,1	36,4	36	36,5
Monetary sector (end of period 12-month change, in percent)					
Money (M1)	25,3	-3,8	8,7	14,5	14,1
M3[1)]	44,5	9,6	21,8	10.7	13,6
Domestic credit to non-government	36,9	35	15,9	16.0	23,2
Balance of payments (in percent of GDP)					
Current account balance	-15,5	-17,1	-5,7	-8,5	-9,1
Export of goods	21.6	22	19,4	19,8	21,9
Import of goods	44,1	44,6	34,9	34,5	36,9
Trade of goods balance	-22,5	-22,3	-15,5	-14,7	-15,0
Capital and account balance	17,9	12,4	11,7	4,2	4,4
External debt	60.2	63,6	76.0	79,5	77,1
of which: Private external debt	39,5	45	51,7	48,5	45,6
Gross official reserves (in billions of euro)	9,5	8,2	10,6	11,3	10,2
REER (annual average change, in percent; + indicates appreciation)	7,2	6,4	-7,1	-0,3	1,8

[1)] Excluding frozen foreign currency deposits.

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Sources of data: the National Bank of Serbia and Serbian Statistical Office, unless stated otherwise.

MPC Meetings and Changes in the Key Policy Rate

Date	Key policy rate (p.a., in %)	Change (in basis points)
MPC meetings held		
12 January	9.5	0
21 January	9.5	0
4 February	9.5	0
22 February	9.5	0
5 March	9.5	0
23 March	9	-50
08-Apr	8.5	-50
20-Apr	8.5	0
11 May	8	-50
MPC meetings		
20 May		
04-Jun		
22-Jun		
6 July		
20 July		
5 August		
19 August		
7 September		
21 September		
7 October		
21 October		
5 November		
19 November		
7 December		
21 December		

Press releases from NBS Monetary Policy Committee meetings

Press release from the MPC meeting held on 22 February 2010

Following discussion of current economic developments, the NBS Monetary Policy Committee decided to keep the key policy rate at 9.5 percent.

In its meeting today, the MPC also adopted the February 2010 Inflation Report.

The next MPC meeting will take place on 5 March 2010.

Press release from the MPC meeting held on 5 March 2010

Committee decided to maintain the policy rate at 9.5 percent and assessed that the success in respect of inflation target achievement will provide room for further monetary policy relaxation.

The MPC also adopted a new Decision on Banks' Required Reserves with the National Bank of Serbia, effective as of 18 March 2010 that will streamline and lower the reserve requirement on both dinar and foreign exchange liabilities. The present reserve requirement regime is overly complex, with a large number of exemptions and deductions, causing the effective reserve requirement rate to significantly deviate from the statutory rates. With the enactment of the new Decision, the NBS expects to reclaim the ability to use reserve requirements as an effective policy tool.

The new Decision changes and expands the required reserve base by way of reducing the number of exemptions from foreign currency reserve requirements, and at the same time, significantly lowers the reserve requirement ratios – from the present 10 to 5 percent on the dinar base, and from the present 40 and/or 45 to only 25 percent on the foreign currency base. The new reserve requirement ratio on foreign currency deposits will be phased in gradually over 2010, and any excess amount of allocated required reserves will be returned to banks in three monthly instalments beginning from February 2011. Effectively, a one year transition period is envisaged for the introduction of the new regime. At the same time, measures will be taken to stimulate deposit accumulation, foreign borrowing and lending by banks.

The MPC has also adopted amendments to the Decision on Special Facilities Supporting the Country's Financial Stability, aligned with the new Decision on Required Reserves and retaining facilities for banks signatories to the Financial Stability Support Programme. Further, in line with agreements reached at the meeting of the European Bank Coordination Initiative, held on 26 February 2010 in Vienna, the above amendments envisage lowering of banks' exposure to Serbia to 80 percent of current levels, effective as of April 2010.

Press release from the MPC meeting held on 23 March 2010

After reviewing current economic developments, the NBS Monetary Policy Committee decided to lower the key policy rate by 0.5 percentage points. As of today, the key policy rate equals 9 percent.

Governor Jelašić will hold a press conference later in the day to explain the main reasons behind the MPC's decision.

The next MPC meeting is scheduled for 9 April 2010.

Press release from the MPC meeting held on 8 April 2010

After reviewing current economic developments at its meeting today, the NBS Monetary Policy Committee decided to cut the key policy rate by 0.5 percentage points to 8.5 percent.

In taking this decision, the MPC had in mind zero growth in core inflation in Q1 and headline inflation trending below the lower bound of the target. Furthermore, aggregate demand was lower than expected in Q1 and its disinflationary effect is likely to continue in the coming period as well. Contraction in aggregate demand is signalled by a higher than anticipated fall in GDP in Q4 2009 and expectations of slower economic recovery in Q1.

The MPC judges that FX swap auctions that the NBS started organising on 6 April will serve as a fillip to direct interbank trading and pave the way for the central bank to scale back its participation in the interbank foreign exchange market.

Though the MPC decided to ease the monetary policy stance in light of the above disinflationary factors, it also noted that some uncertainties around the outlook for inflation persist, involving primarily the scale and pace of the depreciation pass-through to prices, further movements in food prices and the monetary effect of fiscal policy in the coming period.

Press release from the MPC meeting held on 20 April 2010

After reviewing current economic developments at its meeting today, the NBS Monetary Policy Committee decided to maintain the key policy rate at 8.5 percent.

The next MPC meeting will take place on 10 May.