

5. Prices and the Exchange Rate

Since the beginning of the year, inflation in Serbia has been extremely low, the cumulative growth rate in the first seven months is 2%. The key contribution to the rapid disinflation comes from the stability/appreciation of the dinar and reduced domestic demand. Another contribution to disinflation was the absence of supply shocks (energy prices, agricultural products, taxes etc.) that, in recent years had a strong impact on the inflation growth in Serbia. Occasional inflation leaps in the previous part of the year are mostly the result of the increase in administratively controlled prices, and temporary weakening of the dinar. Throughout this year, the inflation is expected to be among the lowest in the last few years and around the upper limit of the target interval. The nominal exchange rate was generally stable during the first five months, only to depreciate by 3% in June, after which it stabilized again. The real exchange rate appreciated by 4% from the beginning of the year to the end of July, while compared to the same period last year, the dinar strengthened in real terms by over 10%. A real dinar appreciation favors the reduction in inflation, improves the balance sheets of the companies and other, but at the same time has a negative effect on the price competitiveness of the Serbian economy, which slows down the improvement of the reduced, but still high deficit in the current account balance.

Prices

The trend of reducing inflation is continued

The downward trend in inflation, started in Q1, continued in the second quarter. Although the price growth in Q2 amounted to 1.7% (i.e. 7.3% when annualized), July deflation of -0.9% indicates that these were one-off adjustments in the price level, rather than accelerating inflation (Table T5-1). Overall inflation since the beginning of the year amounts to about 2%, i.e.

3.5% per annum. After reaching a maximum value of 12.7% in January, year-on-year inflation rate started to decline, and in July, it amounted to 8.6%. Year-on-year inflation is still above the upper limit of the NBS target band, amounting to 2.5%-5.5% (Graph T5-2), but its sharp drop towards the upper limit of the corridor is expected in the following months. Year-on-year inflation will continue to decline till the end of the year, both for the expected low inflation rate in the following months, and high inflation in the second part of the year 2012, (in the period August-October of 2012, inflation amounted to 6.7%). Underlying inflation (y-o-y) declines as well, although its fall is slightly milder than the overall inflation, as the decline of overall inflation was

Table T5-1. Serbia: Consumer Price Index, 2007-2013

	Consumer price index				
	Base index (avg. 2006 =100)	Y-o-y growth	Cumulative index	Monthly growth	3m moving average, annualized
2007					
dec	113.0	11.0	11.0	1.2	13.1
2008					
dec	122.7	8.6	8.6	-0.9	4.4
2009					
dec	130.8	6.6	6.6	-0.3	1.6
2010					
dec	144.2	10.2	10.2	0.3	11.7
2011					
mar	152.2	14.1	5.5	2.6	24.1
jun	154.0	12.6	6.8	-0.3	4.8
sep	153.3	9.3	6.3	0.2	-1.7
dec	154.3	7.0	7.0	-0.7	2.5
2012					
mar	157.4	3.4	2.0	1.1	8.4
jun	162.4	5.4	5.3	1.2	13.2
sep	169.1	10.3	9.6	2.3	17.7
dec	173.1	12.2	12.2	-0.4	9.9
2013					
jan	174.1	12.7	0.6	0.6	0.7
feb	175.1	12.5	1.2	0.6	3.0
mar	175.1	11.2	1.2	0.0	4.7
apr	176.5	11.5	2.0	0.8	5.6
maj	176.5	10.0	2.0	0.0	3.2
jun	178.2	9.7	2.9	1.0	7.3
lul	176.6	8.6	2.0	-0.9	0.3

Source: NBS

more affected by the lower growth in the prices of food, alcohol, tobacco and energy than the prices of other goods and services.

Excuse for a restrictive monetary policy cannot be found in the current inflation

Although inflation has been very low since the beginning of the year, NBS continues to implement restrictive monetary policy. Cumulative inflation in the first seven months amounted to 2%, i.e. 3.5% when annualized, while the reference rate was 11%. It is obvious that the excuse for a high reference rate cannot be found in this year's inflation. In previous QM issues we wrote about the fact that the y-o-y inflation is not a good indicator for making decisions on monetary policy in conditions of high and variable inflation characterized by sudden breaks, which is the presently the case in Serbia. High year-on-year inflation in the previous part of 2013 is the consequence of a high inflation in the previous year, which cannot be influenced by the current monetary policy.

... but can in the risks resulting from high imbalances

Although inflation was low in the last part of the year, there are high imbalances in Serbian economy that could destabilize the exchange rate in a short term, which would shortly after transfer to inflation in highly euroized Serbian economy. Fiscal and foreign deficit, as well as the public and foreign debt are high, and bad loans reached alarming proportions (see Chapters 4,6 and 7). Under such circumstances, restrictive monetary policy attracts foreign capital into the country, including the speculative, and contributes to the stabilization of the exchange rate, which has a significant impact on inflation. On a long run, such a policy isn't sustainable, therefore it is necessary to significantly reduce the fiscal deficit already in the next year and take measures to minimize the negative fiscal implications of possible problems in the banking sector. NBS should adopt measures for encouraging banks to actively solve the problem of bad loans.

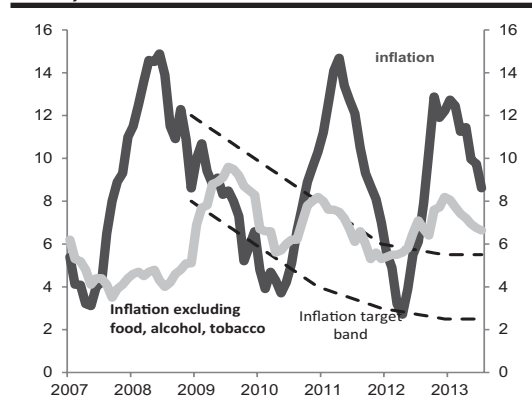
...if a restrictive budget is adopted for the next year, it is possible to reduce the monetary policy restrictiveness

Adoption of the budget for the next year with the deficit lower by 2.5% to 3% of GDP would allow the reduction of monetary policy restrictiveness. Reduced restrictiveness of monetary policy would not directly influence the growth of a bank credit activity, although certain, relatively modest effect would likely exist. The reasons for a low impact of monetary policy to a credit activity and economic trends are numerous and include factors such as: high economy euroization, absence of a clear separation between illiquidity and insolvency of companies and others. However, less restrictive monetary policy would contribute to the reduction of a foreign deficit and economy growth on a long run through the influence on the real exchange rate trend, but the price for that would be a slightly higher inflation. The reduction in the monetary policy restrictiveness would affect a moderate real dinar depreciation, which would contribute to the export growth and reduction of a still high deficit in the current account balance. Depreciated exchange rate would also make the domestic demand more competitive, which would, apart from export growth, contribute to an increase in employment and economic activity in Serbia.

... reduction in the restrictiveness has to be gradual and moderate

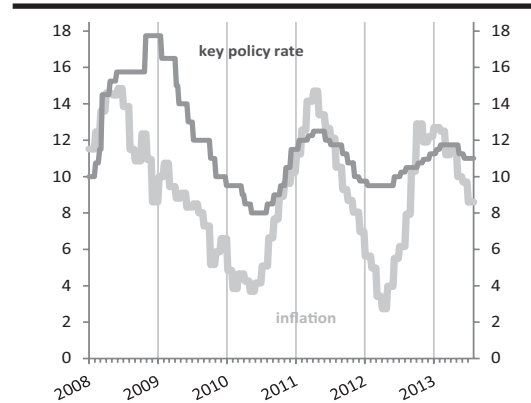
The reduction in the monetary policy restrictiveness, through the reduction of the reference rate and required reserve rate should be gradual and moderate, in order to preserve macroeconomic stability. In highly euroized economy with high internal and external imbalances, a sharp reduction in monetary policy restrictiveness may lead to a strong dinar depreciation, which would

Table T5-2. Serbia: y-o-y inflation rate and underlying inflation and the NBS target band, 2007-2013



Source: NBS

Table T5-3. Serbia: NBS reference interest rate and y-o-y inflation rate, in %, 2008-2013



Source: NBS

5. Prices and the Exchange Rate

again accelerate the inflation and generate high capital losses for the economy, the state and the citizens on the basis of so-called exchange rate differences. Monetary policy needs to balance between inflation, as its primary objective, and other objectives (reduction of external imbalances, employment, etc.), and the result of that „balancing“ in any case should be a one-digit inflation.

**Low price growth
in Q2 and
deflation in July
2013**

In Q2 and July of 2013, the overall price growth was slightly below 0.9%, i.e. 2.6% when annualized. The largest contribution to the growth of consumer price index was given by the growth in the prices of some food products (fruit and meat prices accounted for 93%, i.e. 0.8 pp in the increase of CPI), tobacco (share of 16%, i.e. 0.14 pp, Table T5-4), housing, water and electricity (17%, i.e. 0.16 percentage points), medical products and health services (21%, i.e. 0.19 pp) and culture and recreation (share of 53%, i.e. 0.5 pp). Fall in the prices of other food products excluding fruit and meat (0.99 pp) and services related to the use of means of transportation (0.1 pp) had a disinflationary impact. The prices in Q1 2013, as well as in 2012, significantly contributed to the growth of the consumer price index, while their overall effect in Q2 and in July was disinflationary. A considerable impact of the growth in the prices of vegetables in the first quarter, as well as their decline in the second quarter on the consumer price index is most likely the result of using the same weights for the consumption throughout the year. This means that the growth in the prices of fruit and vegetables that are yet to emerge on the market significantly affect the consumer price index (as was the case in April), although these products are bought to a much lesser extent than the average annual weight shows. When the prices of these products fall significantly (as has already happened with the prices of vegetables, and in the coming months can be expected with the prices of vegetables), it then leads to deflationary trends, although the real jumps and falls never occurred.

Table T5-4. Serbia: Consumer Price Index: Contribution to Growth by Selected Components

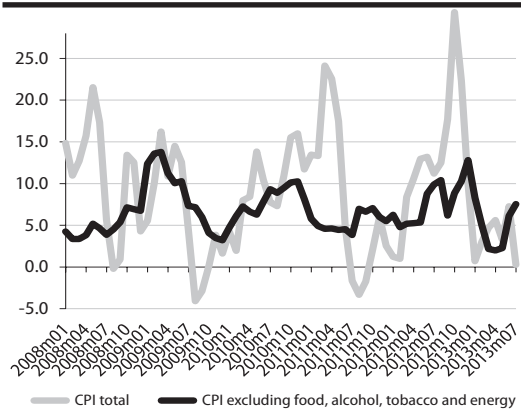
	Share in CPI (in %)	Price increase in Q2 and July 2013	Contribution to overall CPI increase (in p.p.)	Price increase in Q1 2013	Contribution to overall CPI increase (in p.p.)	Price increase in August- December 2012.	Contribution to overall CPI increase (in p.p.)
Total	100.0	0.9	0.9	1.2	1.1	6.5	6.4
Food and non-alcoholic beverages	34.5	-0.7	-0.2	1.5	0.5	8.3	3.2
Food	30.9	-0.7	-0.2	1.6	0.5	8.2	2.9
Alcoholic beverages and tobacco	7.8	2.2	0.2	4.1	0.3	16.9	0.9
Tobacco	4.2	3.4	0.1	5.7	0.2	21.5	0.9
Clothing and footwear	4.6	0.4	0.0	-2.3	-0.1	3.7	0.2
Housing, water, electricity and other fuels	13.0	1.2	0.2	1.2	0.2	4.5	0.7
Electricity	5.1	0.0	0.0	0.0	0.0	1.7	0.1
Furniture, household equipment, routine maintenance	4.1	1.2	0.0	1.6	0.1	5.6	0.2
Health	6.4	3.0	0.2	3.0	0.2	3.3	0.1
Transport	12.3	-0.3	0.0	-1.0	-0.1	3.8	0.4
Oil products	5.1	-1.6	-0.1	-2.4	-0.1	5.0	0.2
Communications	5.0	0.4	0.0	4.1	0.2	5.2	0.2
Other items	12.2		0.6		-0.1		0.4

Source: SORS and QM estimate

**While overall inflation
is decreasing, the
underlying inflation is
increasing significantly**

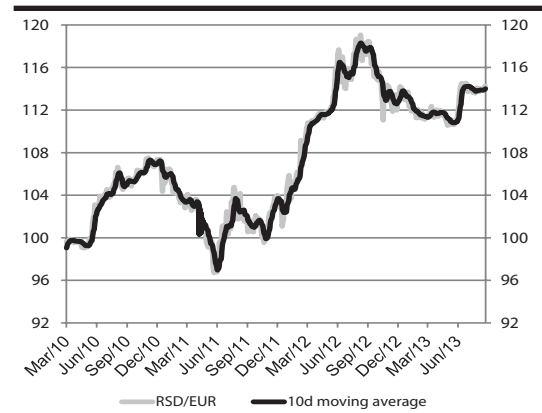
Underlying inflation (inflation excluding food, alcohol, tobacco and energy), has started to decrease since January 2013 and in April it amounted to 0.49%, or 2% when annualized, which was a record low level of underlying inflation rate (Graph T5-5). This was after followed by its significant growth, and in July it amounted to 1.84%, i.e. 7.5% when annualized. The underlying inflation movement largely reflects the impact of systematic factors on the inflation, and in the case of Serbia, the movement of the exchange rate and wages crucially influence the inflation. As from May to July, the exchange rate of the dinar against the euro grew from about 110 to about 114 dinars per euro, one can concluded that it was precisely the change in the exchange rate that had the greatest impact to the underlying inflation trend. For low and stable inflation, in the

Graph T5-5. Serbia: CPI and Underlying Inflation Trend, Annualized Rates, in %, 2008-2013



Source: SORS and QM estimate

Graph T5-6. Serbia: Daily RSD/EUR Exchange Rate, 2010-2013



Source: NBS

conditions of highly euroized economy such as Serbian, it is important that strong exchange rate changes are absent in the future, and such changes would be less probable if the real exchange rate is near the equilibrium level.

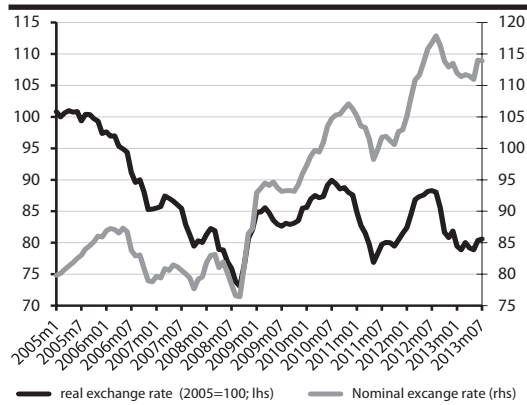
The Exchange Rate

Dinar depreciation in June

The dinar exchange rate was relatively stable from the beginning of the year to May, but in the first half of June it sharply depreciated (in June dinar against the euro nominally weakened by nearly 3%), and throughout following months it stabilized at the level of about 114 dinars per euro (Graph T5-6). The National Bank of Serbia for the first time in 2013 intervened in the foreign exchange market on May 30th, and in the next few weeks sold 275 million Euros in total to mitigate the excessive daily volatility of the exchange rate, but also stopped dinar depreciation trend.

Real dinar appreciation stopped

Graph T5-7: Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly Averages, 2005-2013



Source: NBS, SORS, Eurostat and QM estimates
Note: an increase represents depreciation

During Q2 and July, the real dinar exchange rate against euro depreciated by 0.7%. From the beginning of the year to May, dinar appreciated by nearly 4% compared to December 2012, only to stabilize, after depreciation in June, at a real level that is about 1.5% stronger than the one in December. In addition to depreciation, low inflation rate over previous three months also contributed to a stabilization of the real exchange rate. Historically, the real exchange rate is roughly at the same level as in the late 2011, prior to the strong depreciation in the early 2012 (Graph T5-7).

Strengthening of the dinar in the first five months of 2013 was the result of a high government borrowing, and not the result of a surplus growth in a foreign trade balance or the increase

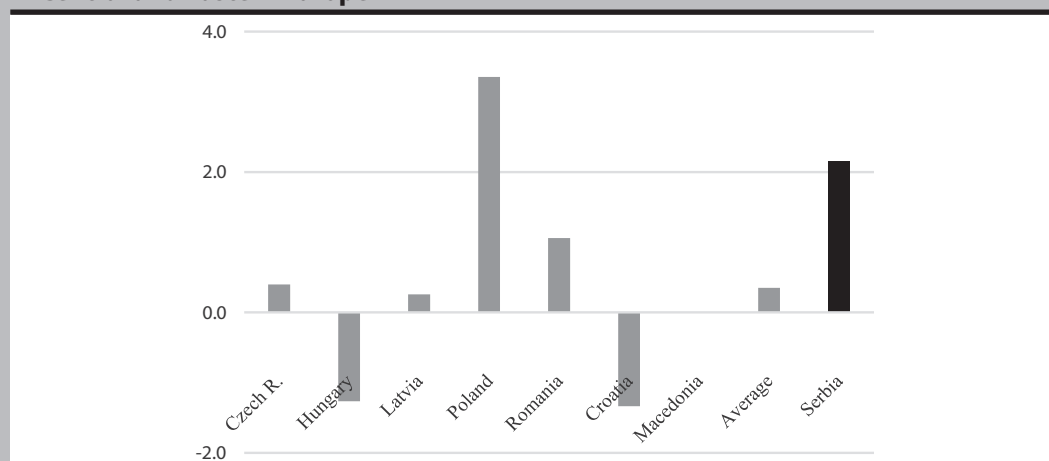
Strengthening of the dinar was the result of government borrowing and was not sustainable on a long-term

in the competitiveness of the Serbian economy. As a high borrowing is not sustainable on a long run, the real exchange rate could be sustainable only if the foreign currency inflow from the government borrowing is replaced with either the inflow of foreign investments or the current account surplus. Because there was no significant inflow of foreign investments, even though the current account deficit is reduced, a current account surplus cannot be expected in the mid-term (in the next few years). Therefore, real depreciation is more probable than dinar appreciation in the future period.

Box 1. Exchange rates in the countries of Central and Eastern Europe

When observing the exchange rate in the countries of Central and Eastern Europe which implement flexible exchange rate policy, one can see, on average, a trend of a mild depreciation (Graph T5-8), but looking at the countries individually, the exchange rate varies depending on specific factors- the discrete measures and circumstances in the economy of a given country. Thus, in the studied group of countries (Czech Republic, Hungary, Latvia, Poland, Romania, Croatia and Macedonia), the highest depreciation occurred in Poland, which was the consequence of a reduced reference rate to a record low level of 2.75% in June. National Bank of Poland cut the referent rate so to stimulate the economic growth, as the country is in a period of a biggest slowdown of economic activity in the last four years. Unlike Poland, national currency in Croatia has strengthened, primarily due to the country's entry into the European Union, while appreciation occurred in Hungary due to a large inflow of foreign investments in the second quarter of this year.

Graph T5-8. Nominal exchange rate depreciation in July in relation to April 2013 (in %) in Central and Eastern Europe



Source: Eurostat, NBS

By excluding the extreme cases of exchange rate depreciation and appreciation in aforementioned countries, a similar, almost neutral exchange rate trend is obtained in the countries of Central and Eastern Europe. As there isn't a global trend in these countries, and the exchange rate moves according to the discrete measures and circumstances in individual countries, the same conclusion could be drawn for Serbia, that depreciation of the dinar exchange rate in the period April-July 2013 is not the consequence of a general international movements, but the cause for dinar weakening is the result of specific factors related to Serbia. The most important negative factors affecting the dinar exchange rate in this period are the poor state of public finances (record-high public debt and extremely high fiscal deficit), as well as negative reviews by IMF and other relevant institutions.