5. Prices and the Exchange rate

Q2 recorded a further acceleration of the inflation, to which the main contributor is the rise in the prices of food products, especially meat, fruit and vegetables. Furthermore, Q2 saw the increase in the year-on-year inflation rate (as the base effect keeping y-o-y inflation rate low was "exhausted"), thus the inflation rate in July exceeded the upper limit of the NBS target band. The underlying inflation (inflation excluding food, alcohol, tobacco and energy) began accelerating in June and July, probably as a consequence of the dinar depreciation "spillover", fiscal expansion and the increases in the prices of food and energy. The inflation at the end of the year will, certainly, exceed the upper limit of the NBS target band (in December 2012, targeted inflation amounts to 4%±1.5%), and probably rise to double digit level (most likely between 10% and 11%). The Dinar depreciated throughout Q2, as well as over July and much of August. Depreciation against the euro, since the beginning of the year to September, amounted to about 12%. As a result of a nominal depreciation, the real exchange rate depreciated as well, but this movement was mitigated by the inflation in Serbia, much higher than in the EU. The real exchange rate against the euro depreciated by about 8%.

Prices

The inflation accelerated in Q2, compared to the previous quarter. The increase in the prices, during Q2, amounted to 3.2% (i.e. 13.2% when annualized), while in the previous quarter, it was 2.0% (i.e. 8.4% when annualized). July recorded slightly lower inflation of mere 0.1% (primarily due to a decrease in the prices of food and vegetables), thus, from the beginning of the year to July, the increase in the prices was 5.4% (Table T5-1).

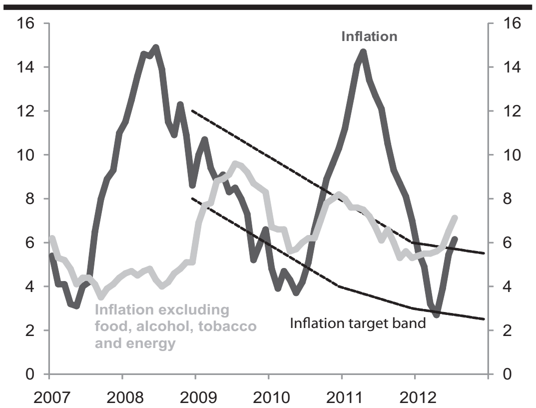
Table T5-1. Serbia: Consumer Price Index, 2007-2012

	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					
mar	133.4	4.7	1.9	1.2	8.0
jun	136.7	4.2	4.5	0.4	10.4
sept	140.3	7.7	7.2	1.3	10.9
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
sept	153.3	9.3	6.3	0.2	-1.7
dec	154.3	7.0	7.0	-0.7	2.5
2012					
jan	154.4	5.6	0.1	0.1	1.2
feb	155.7	5.0	0.9	0.8	1.0
mar	157.4	3.4	2.0	1.1	8.4
apr	158.4	2.7	2.6	0.6	10.6
may	160.5	4.0	4.1	1.4	13.0
jun	162.4	5.4	5.3	1.2	13.2
jul	162.5	6.1	5.4	0.1	11.0

Source: SORS

There was a significant increase, throughout Q2 and July, in the year-on-year inflation rate, which is now exceeding the upper limit of the NBS target band. Although it was already clear throughout Q1 that the monthly inflation rate will accelerate, y-o-y inflation rate continued its decline due to a base effect (i.e. due to a comparison with the extremely high inflation in the same period of the last year), so the y-o-y inflation was running at a record low level of a mere 2.7% in April. However, as of May, the base effect was "exhausted" (i.e. now, the y-o-y inflation rate is compared to the lower price growth in the previous year), rendering the y-o-y inflation rate rapidly grow. In June, y-o-y inflation rate was 5.5%, standing very close to the upper limit of the NBS target band, only to reach 6.1% in July, and thus exceeding the upper limit of the NBS target band (Graph T5-2).

Table T5-2. Serbia: Y-o-y CPI and Underlying inflation rate and NBS target band 2007-2012



Source: NBS

The y-o-y inflation rate will continue to grow in the following part of the year, and at the end of the year, inflation is likely to reach somewhat more than 10%. Given the announced increase in the prices of food (especially meat, but other food products as well), movement in the cereal prices (prices growth caused by the great drought), adjustments to the administratively controlled prices, which have not increased in the first part of the year (e.g. the prices of electricity, gas and certain drugs), as well as the expected increase in the VAT rate, it can be expected the inflation to reach somewhat more than 10% at the end of the year, most likely standing between 10% and 11% (with higher probability of exceeding 11% , than standing below 10%). In the previous QM issue, we discussed the expectations that the inflation will be contained within single digits at the end of the year; however, since then, there has been a rise in the prices of petroleum products, as well as the increase in the food prices, significantly above the expected level.

The price increase in Q2 was mainly the result of the rise in the foodstuffs prices. Two-thirds of total inflation in Q2 resulted from the increased food prices, and this group showed the highest growth in the prices of meat, fruit and vegetables. All other groups of products and services had a much lower price growth and minor contribution to inflation (Table T5-3). Unlike Q2, July inflation stood very low (a mere 0.1%), primarily due to the seasonal cuts of the vegetable prices and stagnation in the prices of most other foodstuffs. The only significant price increase recorded in July refers to the price of the cigarettes (increased primarily due to the increase in the excise duty).

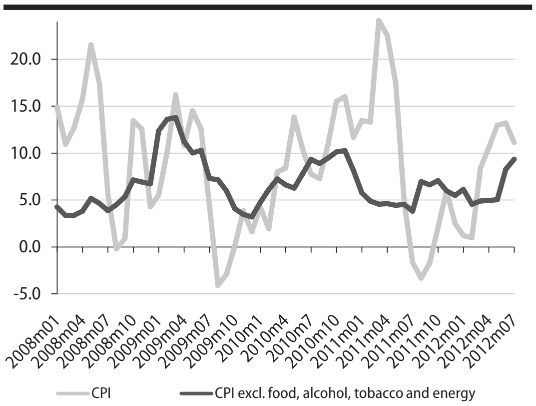
Table T5-3. Serbia: selected components of the Consumer Price Index and their contribution to inflation.

	Share in CPI (in %)	Price increase in Q4 2011	Contribution to overall CPI increase (in p. p.)	Price increase January - May 2011	Contribution to overall CPI increase (in p. p.)	Price increase May - December 2011	Contribution to overall CPI increase (in p. p.)
Total	100.0	3.2	3.2	2.0	2.0	-0.1	-0.1
Food and non–alcoholic beverages	38.8	5.8	2.2	2.0	0.8	-4.1	-1.6
Food	35.0	6.2	2.2	2.1	0.7	-4.8	-1.7
Alcoholic beverages and tobacco	5.4	0.6	0.0	5.0	0.3	-1.4	-0.1
Tobacco	4.0	0.0	0.0	5.8	0.2	-2.8	-0.1
Clothing and footwear	5.1	1.0	0.1	-0.7	0.0	3.7	0.2
Housing, water, electricity, gas and other fuels	16.5	0.8	0.1	1.5	0.2	2.3	0.4
Electricity	7.2	0.0	0.0	0.0	0.0	0.0	0.0
Furniture, household equipment, routine maintenance	4.4	3.9	0.2	2.1	0.1	5.8	0.3
Health	4.3	1.1	0.0	0.8	0.0	-0.4	0.0
Transport	10.5	2.2	0.2	5.7	0.6	3.1	0.3
Oil products	4.8	1.5	0.1	8.5	0.4	3.0	0.1
Communications	4.1	0.1	0.0	-0.5	0.0	5.4	0.2
Other items	11.0		0.3		0.1		0.2

Source: SORS and *QM* estimates

Underlying inflation that has been very stable over the first five months of the year showed the signs of accelerating in June and July (Graph T5-4). Underlying inflation (inflation excluding foodstuffs, alcohol, tobacco and energy) over the first five months of the year amounted to an average of 0.4% per month, or 5.2% when annualized. However, underlying inflation in July stood at 1.1%, and 0.8% in August, i.e. an average of 0.9% per month, or 11.5% when annualized. The acceleration of underlying inflation is likely the result of „spillover" of the fiscal expansion and dinar depreciation, as well as the food and energy price increase. Due to the global scale of the drought, in the following 2-3 quarters, the prices of agricultural and industrial products are expected to increase, which, due to a high share of food in the costs of living, will significantly affect the increase of the inflation in Serbia.

Graph T5-4. Serbia: CPI and Underlying Inflation Trend, Annualized Rates, in %, 2008-2012

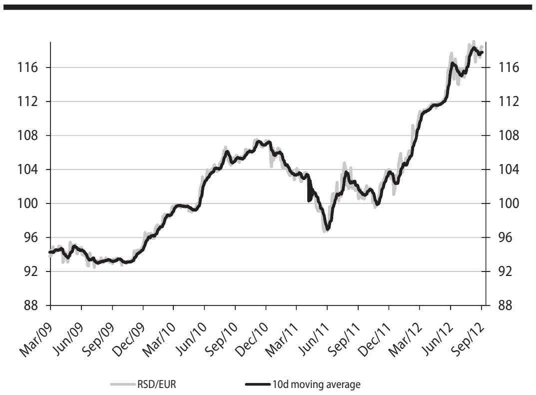


Source: SORS i *QM estimate*

The exchange rate

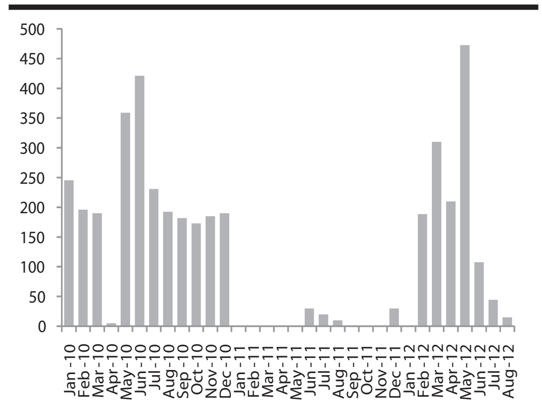
The dinar has depreciated since the beginning of the year, thus the exchange rate against the euro, from the beginning of the year to September, weakened by about 12%. During Q2, dinar nominally weakened against the euro by 4% (Graph T5-5). July and early August saw accelerating depreciation, making the dinar additionally decrease by nearly 3% in less than month and a half. In the mid-August, NBS decided to increase the share in the dinar portion of allocations of the foreign exchange required reserve. In addition, NBS, in the period from May to August, increased the reference interest rate by a total of one percentage point (from 9.50% to 10.50%). These measures contributed the dinar depreciation trend to halt in the mid-August for the moment. NBS in April and May carried out considerable interventions in the foreign exchange market (record high 473mn Euros were sold in May, see previous QM issue), but as of June 1st (when NBS sold 89.1mn Euros) there hasn't been any serious direct NBS intervention.

Graph T5-5. Serbia: Daily RSD/EUR Exchange Rate, 2009-2012



Source: NBS

Graph T5-6. Serbia: NBS intervention, sale of foreign currency, Monthly averages, millions of Euros 2010–2012



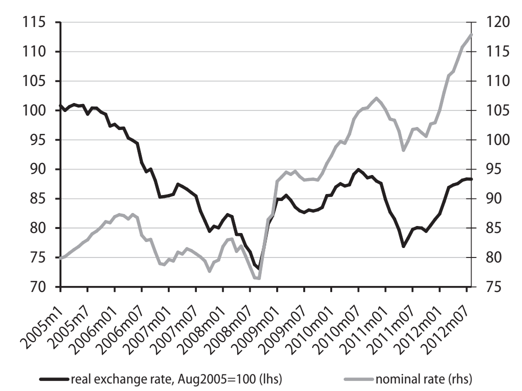
Source: NBS

During Q2, the real exchange rate of the dinar against the Euro depreciated by 1.5%. From January to August, the real exchange rate depreciated against the euro by about 8%. Lower depreciation of the real than the nominal exchange rate is the consequence of the inflation being quite higher in Serbia than in Eurozone (from the beginning of the year to August, inflation is Serbia amounted to 6.5%, and in the Eurozone, it was mere 0.9%). However, despite the additional depreciation, the real exchange rate against the euro is still not the lowest since the beginning of the crisis, as it remains stronger than the July level of the year 2010. Namely, the real exchange rate from July 2010 to May 2011, appreciated by nearly 15%, and although it has been steadily depreciating since, only now does it return near the level of July 2010 (Graph T5-7).

The main initiator of the dinar depreciation in the previous part of the year was a high imbalance in the balance of payments in Serbia (see the section on Balance of Payment in Serbia). The demand for foreign exchange was significantly higher than the supply, both on the basis of the deficit in the current account and the capital outflows from Serbia. Imbalance between supply and demand for foreign exchange was partly financed by spending the foreign exchange reserves, while the dinar depreciation decreased the imbalance. The movements at the foreign exchange market by the end of the year are quite unpredictable, thus it is difficult to assess the exchange rate trend. The rest of the year is expected to see the continuation of the deficit reduction in the current account balance, but the movements in the capital balance are quite uncertain.

The crisis in the EU, but as well Serbia's credit rating drop and the lack of the agreement with the IMF, will affect the reduction in the income of the private capital, and the possibility of its outflow is not excluded. However, it is possible that, in the next few months, the state is to provide foreign currency loans (bilateral and commercial) for financing the fiscal deficit and debt refinancing (foreign and local currency), which would increase the supply of the foreign currency. The increase in the supply of the foreign currency, based on the government debt, can temporarily provide the exchange rate stability, or even its appreciation. Nevertheless, the more permanent exchange rate stability is impossible without a re-growth of the private investments in Serbia, and for that, it is necessary to renew the confidence of commercial investors in the solvency of the state and external liquidity of the country.

Graph T5-7. Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly averages, 2005–2011



Source: NBS, SORS and *QM* estimate
Note: an increase represents depreciation