

## 5. Prices and the exchange rate

The price growth in the first four months of 2012 accelerated, primarily due to the increase in the prices of food, gasoline and cigarettes, while the underlying inflation remained stable. However, year-on-year inflation rate was very low, mainly because of the base effect, i.e. due to a comparison with a high price growth over the same period last year. “Base effect” will soon be exhausted, thus from May on, the increase in the y-o-y inflation rate is expected. The increase in inflation in the coming months will be affected by a sharp depreciation of the dinar, as well as a significant fiscal expansion over Q1 and April. On the other hand, low aggregate demand and a calming down of the energy and commodity prices (mainly agricultural products and foodstuff) on the world market will act disinflationary. Besides the fact that year-on-year inflation rate will rise later in the year, if there are no major external shocks, it will most likely remain single-digit by the end of the year, even with the possible increase in the rate of VAT. The dinar strongly depreciated since the beginning of the year, and this trend has accelerated since the mid of May. Depreciation is a result of a high fiscal deficit, growing balance of payment deficit and political uncertainties regarding the formation of a new government. The real exchange rate has depreciated as well, and now, the whole real appreciation, which lasted from the mid of 2010 to the mid of 2011, is practically “cancelled”. Although the depreciation is basically favourable for the export competitiveness, it increases the expenses of servicing debt for the economy that is highly euroized. Therefore, it is not clear whether depreciation has a net positive impact on the businesses of all the exporters.

### Prices

First four months of the year 2012 are marked by acceleration in inflation, even though y-o-y price growth rate was record low due to the base effect. The price growth in the first four months amounts to 2.6%, i.e. 8.1% when annualized. If we consider the period from February to April, the price growth is even higher and it amounts to 10.6% when annualized. For comparison, let us remind that inflation in the entire second half of the year 2011 was mere 0.2%, i.e. about 0.4% when annualized. However, in April, year-on-year inflation rate stood at mere 2.7%. The reason for such low y-o-y inflation rates is primarily the base effect; namely, the same period last year recorded an exceptionally high inflation (e. g., the increase in the prices in the first four months of 2011 amounted to as much as 5.5%), and now, because of the comparison with such a high base, year-on-year inflation rate stands very low.

Year-on-year inflation has been in a constant fall since April in the last year, now standing at the lower limit of NBS target band, but from May it will begin to increase. As of May, “base effect” will be exhausted, thus the y-o-y inflation rate will certainly be on the rise. It is possible to expect, though not certain, that the monthly inflation rates later in the year will be higher than in the second half of the previous year, standing probably at a similar level as in the first quarter of 2012. Both significant depreciation of the dinar, which we have recorded since the beginning of the year, as well as a high fiscal deficit from the first four months will contribute to a higher inflation rates. On the other hand, the energy and commodity prices (mainly agricultural products and foodstuff) in the last few months have been in a decline on the world market; in addition, *futures* prices indicate that even by the end of the year, these prices will remain at the lower level than at the beginning of the year, and possibly fall further. Such dynamics in the prices of energy and commodities was primarily the result of the increased risks in the global economy, possible further escalation of the crisis in the Euro zone and slow recovery of the U.S. economy. Finally, one-time inflation jump in the second half of the year can be expected, due to a possible increase in the VAT rates, but also the increase in the administratively controlled prices (electricity, heating, etc...). Taking into account all mentioned factors, it is clear that there are plenty of uncertainties concerning inflation trends later in the year. Nevertheless, we expect that, unless there are no extreme shocks (e.g., the collapse of the eurozone due to the sovereign

debt crisis) at the end of the year, inflation will be exceeding the upper limit of the NBS target band for December (target band for December is 2.5% to 5.5%), but still remaining single-digit.

**Table T5-1. Serbia: Consumer Price Index, 2007-2011**

|             | Consumer price index              |              |                     |                   |                                     |
|-------------|-----------------------------------|--------------|---------------------|-------------------|-------------------------------------|
|             | Base index<br>(avg. 2006<br>=100) | Y-o-y growth | Cumulative<br>index | Monthly<br>growth | 3m moving<br>average,<br>annualized |
| <b>2007</b> |                                   |              |                     |                   |                                     |
| dec         | 113.0                             | 11.0         | 11.0                | 1.2               | 13.1                                |
| <b>2008</b> |                                   |              |                     |                   |                                     |
| dec         | 122.7                             | 8.6          | 8.6                 | -0.9              | 4.4                                 |
| <b>2009</b> |                                   |              |                     |                   |                                     |
| dec         | 130.8                             | 6.6          | 6.6                 | -0.3              | 1.6                                 |
| <b>2010</b> |                                   |              |                     |                   |                                     |
| 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                                |
| <b>2011</b> |                                   |              |                     |                   |                                     |
| 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                                 |
| <b>2012</b> |                                   |              |                     |                   |                                     |
| 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                                |

Source: SORS

The price growth in the first four months of this year is primarily the result of the rise in the prices of foodstuff, as well as the increase in the prices of gasoline and cigarettes. Food products are “responsible” for the 40% of the overall inflation, primarily because the fruit prices increased, as well as the prices of eggs and dairy products. Of the total price growth, 68% is caused by the rise in the prices of foodstuff, gasoline and cigarettes (Table T5-2).

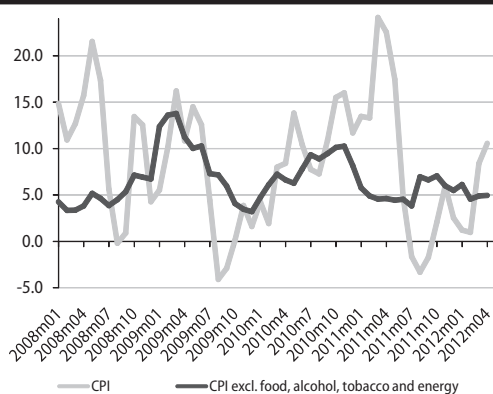
**Table T5-2. Serbia: Consumer Price Index: Contribution to Growth by Selected Components**

|   | Share in CPI (in<br>%) | Price increase in<br>Q4 2011 | Contribution to<br>overall CPI<br>increase (in p. p.) | Price increase<br>January - May<br>2011 | Contribution to<br>overall CPI<br>increase (in p. p.) | Price increase<br>May - December<br>2011 | Contribution to<br>overall CPI<br>increase (in p. p.) |
|---|------------------------|------------------------------|---|---|---|--|---|
| Total   | 100.0                  | 2.6                          | 2.6   | 7.1                                     | 7.1   | -0.1                                     | -0.1  |
| Food and non-alcoholic beverages                    | 38.8                   | 2.8                          | 1.1   | 11.0                                    | 4.2   | -4.1                                     | -1.6  |
| Food  | 35.0                   | 3.0                          | 1.1   | 11.4                                    | 3.9   | -4.8                                     | -1.7  |
| Alcoholic beverages and tobacco                     | 5.4                    | 5.1                          | 0.3   | 12.8                                    | 0.6   | -1.4                                     | -0.1  |
| Tobacco   | 4.0                    | 5.8                          | 0.2   | 16.0                                    | 0.6   | -2.8                                     | -0.1  |
| Clothing and footwear                               | 5.1                    | -0.2                         | 0.0   | -0.3                                    | 0.0   | 3.7                                      | 0.2   |
| Housing, water, electricity, gas and other fuels    | 16.5                   | 1.6                          | 0.3   | 7.1                                     | 1.2   | 2.3                                      | 0.4   |
| Electricity   | 7.2                    | 0.0                          | 0.0   | 13.5                                    | 0.9   | 0.0                                      | 0.0   |
| Furniture, household equipment, routine maintenance | 4.4                    | 3.2                          | 0.1   | 2.1                                     | 0.1   | 5.8                                      | 0.3   |
| Health  | 4.3                    | 1.4                          | 0.1   | 5.0                                     | 0.2   | -0.4                                     | 0.0   |
| Transport   | 10.5                   | 6.7                          | 0.7   | 6.0                                     | 0.6   | 3.1                                      | 0.3   |
| Oil products  | 4.8                    | 10.1                         | 0.5   | 10.1                                    | 0.4   | 3.0                                      | 0.1   |
| Communications                                      | 4.1                    | -0.5                         | 0.0   | -1.8                                    | -0.1  | 5.4                                      | 0.2   |
| Other items   | 11.0                   |                              | 0.1   |   | 0.3   |  | 0.2   |

Source: SORS i QM estimate

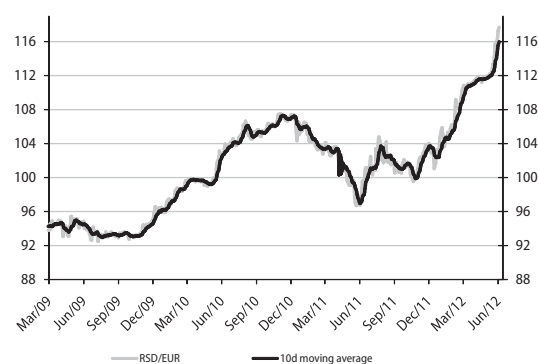
On the other hand, underlying inflation remains stable and relatively low (Graph T5-3). In the first quarter of 2012, underlying inflation amounts to 1.7%, i.e. 5.1% when annualized. The main factor for the low underlying inflation is a weak aggregate demand and low economic activity. However, recent depreciation of the dinar could lead to a certain rise in the underlying inflation over the next several months.

**Graph T5-3. Serbia: CPI and Underlying Inflation Trend, Annualized Rates, in %, 2008-2011**



Source: SORS i QM estimate

**Graph T5-4. Serbia: Daily RSD/EUR Exchange Rate, 2009-2012**



Source: NBS

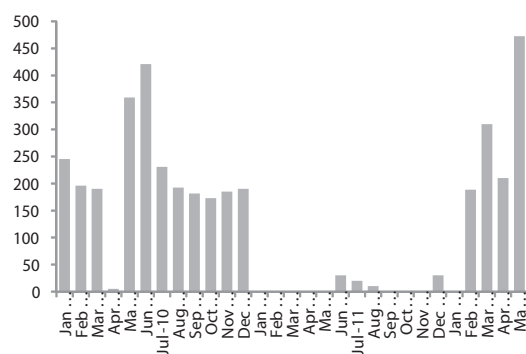
## The exchange rate

The dinar is constantly weakening against euro since the beginning of the year, especially in the previous months, thus, the nominal exchange rate depreciated by nearly 15% from the last week of December to the early June. Over the first quarter, the dinar/euro exchange rate depreciated by 8%. Then, throughout April and early May, rate was mostly stable, only to see another strong depreciation in the second part of May and early June (Graph T5-4).

After a break during most of 2011, NBS again intervened intensively in the market to mitigate the depreciation of the dinar. Since the beginning of the year until the early June NBS has sold 1.2 billion Euros from the foreign currency reserves. In May, NBS sold a total of 473 million Euros, the highest monthly value of the intervention (Graph T5-6). However, while the depreciation is mitigated, it is not stopped.

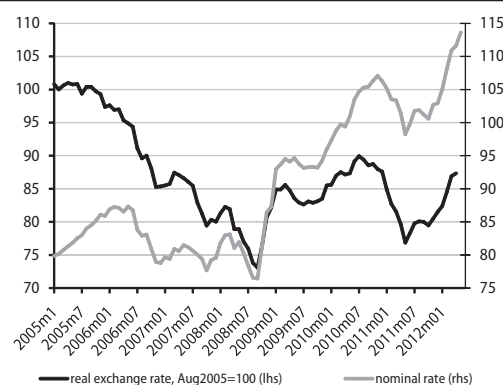
The dinar depreciation is the result of several factors. It was contributed by a strong growth of a fiscal deficit in the first four months of the year 2012, and in relation to that, the increased need for deficit financing and public debt amortization. This creates insecurity among the foreign investors, thus some of them, for now, give up a further investment in the government securities and in order to close their positions in Serbia, they buy Euros, thereby creating depreciation pressure. Moreover, the current account deficit has been relatively high for several months in a row (due to a falling export, but somewhat higher export which is, among other things, a

**Graph T5-5. Serbia: NBS intervention, sale of foreign currency, Monthly averages, millions of Euros 2010-2012**



Source: NBS

**Graph T5-6. Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly averages, 2005-2011**



Source: NBS, SORS and QM estimate

consequence of the energy import growth). In Q1, the current account deficit amounted to 1159 million Euros, considerably higher than 760 million Euros in Q1 last year. Unlike the most of the previous year, when financial account was mostly in big plus, in Q1 2012 it was balanced (due to the outflow from purchase of Greek shares in Telekom, thus much lower portfolio investment inflow than in Q1 of the previous year<sup>1</sup>). As a result of a higher current account deficit and quite modest net inflows of the financial account, the overall balance of payment is in a deficit, which also creates a substantial depreciation pressures. Finally, the political uncertainty regarding the formation of a new government, as well as their policy to be implemented<sup>2</sup>, also increases the risk for the foreign investors in Serbia, which again has a negative impact on the rate. The increase of the NBS reference interest rate and the other measures adopted by NBS in the early June, could contribute, not only to the stabilization of the dinar, but also to a moderate increase in its value. However, the dinar exchange rate will essentially depend on the fiscal policy in the coming years, but as well on the factors to which both the Government and NBS have a relatively modest impact. One of the most significant rate determinants is the inflow of the foreign capital in the form of foreign investments and loan, whose amount depends both on the domestic factors (economic environment) and the trends in EU and narrow Region. The possible crisis in EU could have a negative impact on the economy of Serbia from a lower capital inflow, as well as from reduced demand for goods from Serbia.

From the beginning of the year to the April, the real dinar/euro exchange rate depreciated by some 7.2%. Looking at a slightly longer period, from May 2011 to April 2012, the real exchange rate depreciated by as much as 13%, therefore, the real appreciation that lasted from the mid 2010 to the mid 2011 was largely “cancelled” (Graph T5-7). The real exchange rate is now roughly standing at the level as in the first half of the year 2007. The depreciation rate is generally favourable for the export competitiveness of Serbia; however it leads to the increase of the expenses of servicing debt, both for the country and for the private sector. Most of the exporters from Serbia have debts pegged to the euro, and many of them also have import component in their own expenses, thus it is not certain that depreciation for a short term has a positive effect even on the income of the most exporters. In the medium term, the effect of the depreciation is almost certainly positive, because in that period companies and citizens can change their behaviour so to adjust to the new circumstances.