

5. Prices and the Exchange rate

During Q3 and October, inflation was moving below the lower limit of the NBS target band and at the end of October it stood at 1.8%. Low domestic demand and reduced costs in food production are most significant factors that affect the maintenance of inflation at a very low level compared to normal value in Serbia. Since the beginning of Q3 and up to late October underlying inflation (Measured by CPI excluding food, energy, alcohol and tobacco) was also at an extremely low level and it stood below the lower limit of NBS target band, mostly due to a low aggregate demand and low imported inflation. Poor deflation was recorded during three out of four previous months (July, August, October), while only September had a positive inflation at a relatively high level, mainly due to the seasonal increase in the prices of food (mostly fruits and vegetables). In the following year fiscal policy and macroeconomic trends will act deflationary- salaries and pensions will decline, while the economy will be in recession. If the NBS does not allow the dinar depreciation, the inflation will remain below the lower limit of the corridor by the middle of 2015. Throughout Q3, dinar nominally depreciated by about 2.6%, and a moderate depreciation occurred in October and November (additional dinar weakening by about 1.4%). Depreciation pressures are influenced by the global factors (uncertainty in international financial market, the reactions of the Fed and ECB), as well as specific factors related to Serbia (deterioration of the external balance, high fiscal deficit, high and growing public debt, as well as country's low credit rating). The real depreciation of about 2.2% in Q3 and 0.7% in October (total of 1.9% since the beginning of the year), as well as the expected continuation of the real depreciation in November could influence the improvement of the economy competitiveness with an acceptable increase in the costs of credit servicing and inflation costs. Moderate inflation is even desirable in order to mitigate the recession and efficiently implement a fiscal consolidation measures.

Prices

Inflation moves below the lower limit of the NBS target throughout Q3 and October

During third quarter the year-on-year inflation ranged below the lower limit of the tolerated target deviation, and it continued such a trend in October (Table T5-1). Underlying inflation (measured by the consumer price index excluding the prices of food, alcohol, tobacco and energy) is also below the lower limit, which is a consequence of a fall in a domestic demand and recession. Due to a strong recession and a fall in domestic demand, the effect of dinar depreciation on inflation is reduced. Reduced costs in food production due to a good agricultural season on a world and domestic demand, low pressures arising from import prices, as well as the absence of mitigation of the monetary policy restrictiveness (key interest rate remained at a relatively high 8.5% during October and Q3) have also had a significant disinflationary effect. The price growth in Q3 was lower than expected and amounted to a mere 0.4%, mostly because the correction of the regulated prices was absent- increasing prices of electricity, because of a fall in world oil prices and, consequently, only a slight growth in the prices of the petroleum products (due to the weakening of the dinar against the dollar) and because of almost neutral trends in the food prices- rising prices of food and declining vegetable prices in Q3. October was marked by a slow deflation of about -0.2%, mainly due to the falling prices of unprocessed foods- fruit and fresh meat. Low inflation, next to the long-term impact factors (such as low aggregate demand) was contributed by the one-off factors- low growth of the regulated prices (due to price adjustments of the electricity that, although planned, were missing and are not going to be implemented until the end of the this year), low growth in the prices of primary commodities in the country and the world market. Factors with a long-term impact in the following period will further have an enhanced disinflationary effect because of the reduction of wages in the public sector and pensions, as well as other measures of fiscal consolidation. The decline of the expenses in the food production was above the NBS expectations, which in addition to aforementioned, stands out as being the main reason for the failure to return the inflation within the limits of the target band

NBS reduced the key interest rate in November

Table T5-1. Serbia: Consumer Price Index, 2008-2014

	Consumer price index				
	Base index (avg. 2006=100)	Y-o-y growth	Cumulative index	Monthly growth	3m moving average, annualized
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					
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					
mar	175.1	11.2	1.2	0.0	4.7
jun	178.2	9.7	2.9	1.0	7.3
sep	177.3	4.8	2.4	0.0	-2.0
dec	176.9	2.2	2.2	0.2	-0.9
2014					
jan	179.5	3.1	1.5	1.5	4.4
feb	179.7	2.6	1.6	0.1	7.5
mar	179.1	2.3	1.2	-0.3	5.1
apr	180.1	2.0	1.8	0.6	1.4
may	180.2	2.1	1.9	0.1	1.1
jun	180.4	1.2	2.0	0.1	2.9
jul	180.2	2.0	1.9	-0.1	0.2
aug	179.9	1.5	1.7	-0.2	-0.7
sep	181.2	2.1	2.4	0.7	1.6
oct	180.8	1.8	2.2	-0.2	1.3

* Three-month moving average of a price growth rose to an annual level. (For example, the March value is obtained by raising the average monthly price growth in January, February and March to an annual level).

Source: SORS.

structural imbalances in the economy of Serbia (high fiscal and foreign trade deficit, high level of NPLs in the economy) and the risks concerning the uncertainties in international environment (geopolitical tensions related to the crisis in Ukraine, a slow recovery of the economy in the euro zone countries and the reduction in the expansiveness of Fed's monetary policy). It is possible that not even greater easing of monetary policy would have a more significant effect on inflation in the conditions of a low and falling aggregate demand, but it would be an adequate response of the central bank to the economy's entering the recession. The reduction of pensions and wages in the public sector in the following period will contribute to an additional reduction in domestic demand and consequent growth of deflationary pressures, while the implementation of fiscal consolidation measures and structural reforms at the same time should reduce the risks in Serbia's economy, which would create space for additional easing of monetary policy.

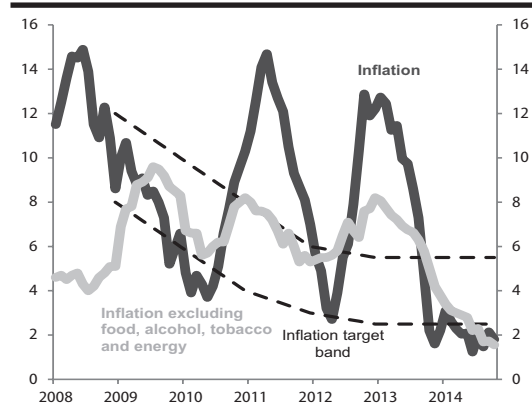
More restrictive monetary policy of the Fed and ECB's monetary policy easing

The reduction in the expansiveness of Fed's monetary policy continued in Q3, so that the down-sizing of the quantitative easing program ended in accordance with the planned schedule. However, it is uncertain when exactly the increase of the Fed's base rate will be initiated and to what extent it will be increased. These uncertainties regarding the implementation of monetary policy in the United States have contributed to the moderate turbulence in financial markets in the countries with emerging markets, and thus in Serbia (see the text on Exchange rates). Contrary to Fed's measures, ECB has additionally eased monetary policy due to the existence of strong deflationary pressures in the euro zone. The fall in global economic activity below the predicted valued in Q2 and Q3 reduces chances of global economic growth in 2014 and 2015. The consequence of this is also a drop in the world oil prices and primary agricultural products¹.

in Q3. However, central bank should not only passively observe the realization of its projections, but should implement the measures which would help inflation return within the frames of the target band. Next to extremely low total inflation, underlying inflation is also at a record low level- the lowest since the inflation is measured by CPI (Graph T5-2)

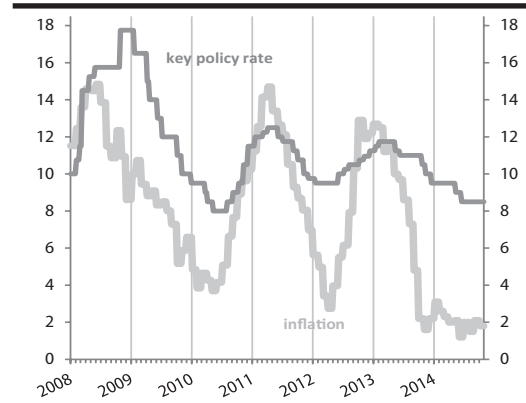
The executive board of the National Bank of Serbia did not change the key interest rate until mid-November, when it was reduced by 50 base points and since when it has amounted to 8%. Although NBS measures aren't quite synchronized with the movement of inflation, caution in the conduct of monetary policy, despite strong disinflationary effect of low aggregate demand and entering into recession, can be partially justified by domestic risks- the existence of struc-

Chart T5-2. Serbia: Y-o-y Inflation Rate and Underlying Inflation and the NBS Target Band 2008-2014



Source: NBS and QM estimates

Chart T5-3. Serbia: NBS Reference Interest Rate and y-o-y Inflation Rate, in %, 2008-2014



Source: NBS

Low inflation in Q3 and deflation in October 2014

The growth in consumer prices in Q3 and in October amounted to 0.2% (individually: 0.4% in Q3 and -0.2% in October). Having that, contrary to expectations, the usual seasonal higher drop in the prices of fruit and vegetable was absent, the prices of food and non-alcoholic beverages increased in Q3, which put forward the total inflation as well. While it is common for the prices of fruit and vegetable to drop in Q3, this year fruit went up by 17% (mostly due to the shortages of citrus in Europe), but then, in October, the fruit got cheaper by about 12%. The prices of vegetable were lower by about 8% in October when compared to the prices in June. The growth in the prices of fresh meat is seasonally expected and it's slightly higher due to a rising prices in the world market and domestic producer prices. Highest positive contribution to the inflation in Q2 and in October, next to the rise in the prices of fruit (an increase of 3%, the contribution of 0.8pp), was the rise in the prices of milk and dairy products (an increase of 2.3%, contribution of 0.11pp), growth in the prices of solid fuels (growth of 4.7%, the contribution 0.13pp), growth in the prices of vehicle insurance (an increase of 26%, the contribution 0.16pp) and transport services (an increase of 1.6%, the contribution 0.19pp). The largest negative contributions to inflation in Q2 and October were the fall in prices of vegetables (a decrease of 8.4%, the contribution -0,42pp), the fall in prices in fixed telephony (a decrease of 6.1%, the contribution -0,14pp) and the fall

in prices clothing and footwear (down 1.5%, the contribution -0.07pp) (see Table T5-4). The September increase in the prices of food and non-alcoholic beverages was particularly expressed when a positive contribution to inflation of about 0.8pp was noted for the first time after a year. The prices of industrial products excluding food and energy decreased in Q3 due to a low aggregate demand. Clothing and footwear got cheaper, while passenger cars got more expensive (mostly due to dinar exchange rate depreciation, since these prices are, as a rule, stated in euros). The

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

	Share in CPI (in %)	price increase in Q3 2014	Contribution to overall CPI increase (in p.p.)	Price increase in October 2014	Contribution to overall CPI increase (in p.p.)
Total	100.0	0.4	0.4	-0.2	-0.2
Food and non-alcoholic beverages	34.5	0.4	0.1	-1.4	-0.5
Food	30.9	0.4	0.1	-1.6	-0.5
Alcoholic beverages and tobacco	7.8	-0.5	0.0	-0.1	0.0
Tobacco	4.2	0.0	0.0	0.0	0.0
Clothing and footwear	4.6	-1.8	-0.1	0.4	0.0
Housing, water, electricity and other fuels	13.0	0.8	0.1	1.0	0.1
Electricity	5.1	0.0	0.0	0.0	0.0
Furniture, household equipment, routine maintenance	4.1	-1.2	0.0	-0.5	0.0
Health	6.4	-0.4	0.0	0.6	0.0
Transport	12.3	1.4	0.2	0.1	0.0
Oil products	5.1	1.8	0.1	-0.3	0.0
Communications	5.0	-1.3	-0.1	-0.4	0.0
Other items	12.2		0.2		0.2

Source: SORS and QM estimates

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growth of minimum excise tax on tobacco products has not reflected to the rise in the prices of cigarettes (in the conditions of the fall in these products's turnover, the burden fully transferred to the producers). The growth in the prices of energy has mostly occurred due to the increase in the prices of petroleum products. Although the world price of oil fell, due to a dinar weakening against the dollar (oil prices are expressed in dollars), the prices of petroleum products increased by 1.4% (prices in October compared to prices in June). Due to a drop in the prices of oil and food on a world market, import prices expressed in dinars in Q3 slowed down the quarterly growth to 0.6%. The possibility of duty-free import of most agricultural products from EU since of this year reduces the pressures on food prices in the conditions of reduced supply in domestic market. The decline in imported inflation was mitigated by the dinar depreciation in the mentioned period. The growth of import prices on a year-on-year basis amounted to 0.7% at the end of Q3, which reduced the inflationary pressures in the domestic market.

Total and underlying inflation are low

During Q3 and in October, underlying inflation (inflation excluding food, alcohol, tobacco and energy products) is at a stable low level, as it was in the previous two quarters. Its slight growth was recorded in July 2014, when three-month average amounted to 1.2%, i.e. 4.9% when annualized (Graph T5-5). However, as this leap was caused by the sudden changes in the prices of one-off character (increase in the prices of insurance and services from the group of recreation and culture), whose effect disappeared, underlying inflation soon returned within this year's stable low framework and in October three-month average amounted to 0.1%, i.e. -0.4% when annualized. The decline in underlying inflation in August was largely a consequence of cheapening of the fixed telephony services (one-off effect), and in September was a consequence of the expected fall in the prices of tourist packages at the end of summer tourist season. Total inflation in September increased slightly mostly due to a rise in the prices of food, when the annualized three-month average rose to 1.6% from -0.7% in August, while in October, it amounted to 1.3%. Regulated prices recorded a drop in Q3 (quarterly, this has been the first time the inflation was measured by the IPC changes) - mainly due to a falling prices of telephone services, as well as the drop in the prices of medicines and the abolition of TV subscription. The largest part of the reduction has a one-off character. Also, the absence of correction, i.e. growth in the prices of electricity has influenced this decline, but it is certain that this correction will occur in the next period (most likely after completion of the heating season 2014/2015). NBS's recommendation is that the correction of the regulated prices should take place at a pre-planned schedule and in a planned amount, which would undoubtedly contribute to a more certain inflation prediction and more adequate responses of NBS to its movement. The year-on-year growth of regulated prices in Q3 amounted to 3.5% (of which 2.6% since the beginning of the year).

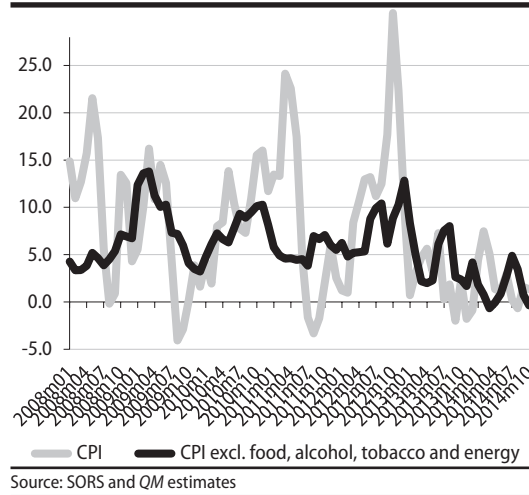
Inflation trends below the lower limit of the target band is expected in Q4 and in early 2015

In Q4 year-on-year inflation will most likely move below the NBS target band. Given that the low aggregate demand will remain the main disinflationary factor in the long term, the return of y-o-y inflation within the limits of the target band is not even expected in Q4 (temporary entry in the target band is possible in November), nor during the first quarter, but only in the second quarter of 2015, when the disinflationary pressures based on food prices are expected to disappear, with the continuing and enhancing of the low base effect functioning. A slowdown in economic activity has a disinflationary effect, while measures of fiscal adjustment will further affect the reduction in aggregate demand, and thus the stability of the prices, while dinar depreciation could have an inflationary effect in the following period, but it's unlikely that a moderate depreciation could to a large extent transfer to a price growth in the conditions of a low and falling domestic demand and economic activity slowdown. The growth of general government deficit to 7% of GDP and public debt to over 70% suggests the poor state of the public finances. Consistent implementation of fiscal consolidation measures and structural reforms, together with the signing the arrangement with the IMF is necessary and would have a positive impact to the decisions of foreign investors on investing in Serbia, contribute to the improvement of credit rating in the competitiveness rating lists. NBS inflation projection in November is lower than in August due to a larger than supposed fall in the prices of raw material, as well as due to the absence of a planned increase in the prices of electricity. Thus, due to aforementioned factors, and primarily due to a low aggregate demand, in the first quarter of 2015 inflation will also continue

to move below the lower limit of the target band (also due to the exit from the accounting of high monthly inflation of 1.5% in January 2014). However, their effect is one-off and from the mid-2015 inflation is expected to return within the limits of the target band, and its approaching to the goal of 4% by the end of 2015. The main inflationary pressures will be the growth of regulated prices (the same as in previous years) and a probable growth in the food prices after next agricultural season. Inflationary trend in Q4 will be affected by the low base effect and dinar weakening during Q3 and in early Q4, but will most probably be neutralized by the effect of a low domestic demand and the fall in the prices of primary agricultural products. It is expected that the core inflation will remain below the limits of the target band even during Q4.

Dinar depreciation will affect inflation growth, but due to the recession it will be a modest one

Chart T5-5. Serbia: CPI and Underlying Inflation Trend, Annualized Rates, in %, 2008-2014



Due to a dinar weakening (in Q3 and continuing in Q4), a positive contribution to inflation could be expected from the rising prices of industrial products excluding food and energy. Highest deviation from the expectations could appear in the trends of food and vegetable prices, as well as the extent to which the realized depreciation will transfer to the prices in the conditions of a low aggregate demand. Further easing of monetary policy will depend on the effects of undertaken monetary and fiscal policy measures (fiscal consolidation and structural reforms) and on the trends in the international environment. Inflationary expectations of the economy and financial sector in the short and long term are within the target band of National Bank of Serbia. Stable inflation expectations suggest that significant

inflationary pressures shouldn't be expected even in the following period (a year and two in advance). Inflation expectations of the financial sector for a period of one year amount to 4.5% in advance according to the *Bloomberg* survey, i.e. 4.0% according to Ipsos survey, and there is a similar situation with the economy expectations. Inflation expectation of the population are at a high 10%, but are largely caused by the lack of knowledge among the population on the macroeconomic trends, given that the citizens evaluate the perceived inflation as several times higher than the actual one

The Exchange rate

Depreciation in Q3, October and November 2014

At the end of Q3 when compared to Q2, dinar weakened against the euro by 2.6%, i.e. 1.5% at the level of average period. Against the dollar, dinar weakened by 9.4% at the end of Q3 (much of this depreciation is the result of euro weakening against the dollar). Slightly weaker depreciation continued in October, when dinar weakened by additional 0.2%, but more significant weakening occurred in November (Graph T5-6). Since the beginning of Q3, there has been a record of constant depreciation pressures, while by the end of November, NBS intervened by selling foreign currency in the amount of 605 million euros. Since the beginning of the year until the end of November, NBS intervened by selling foreign currency in the amount of 1.445 billion euros and buying 200 million euros, while the dinar exchange rate against the euro nominally depreciated from 114.69 to 120.55 RSD/eur, i.e. by 5.1%. Global factors that have contributed to dinar weakening are the uncertainty in the international financial market concerning Ukraine crisis, reduction in the expansiveness of Fed's monetary policy and the uncertainties concerning the effects of ECB's undertaken measures. Domestic factors are unfavorable news on the worsening of the foreign trade balance, reduced inflows of foreign capital, and investor's doubt in the sustainability of public finances and Government willingness in the implementation of structural reforms. The consequence of the aforementioned factors was a modest capital inflow in Q3 and outflow of foreign exchange for payment of dividends to foreign companies, but there was also a greater deleveraging of banks to abroad, thus making non-residents, again as in Q2, the net buyers of foreign exchange in the domestic market. Companies also increased their demand for

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foreign exchange due to increased energy imports after May floods. Global factors have contributed to depreciation pressures strengthening during July and August even in other countries in the region with a similar exchange rate regime, only to completely disappear in September and appear again in October, but in a much lesser extent (Graph T5-7). However, the dinar exchange rate when compared to other currencies depreciated considerably more, and the pressures did not stop even during the period when other currencies appreciated (similar happened in January and May 2014). It can be concluded that dinar depreciation is to a certain extent the result of global factors, but that the factors specific for Serbia (worsening of a foreign trade balance and distrust of investors) also have a great influence on the exchange rate trend. Risk premium mo-

Chart T5-6. Serbia: Daily RSD/EUR Exchange Rate, 2010-2014

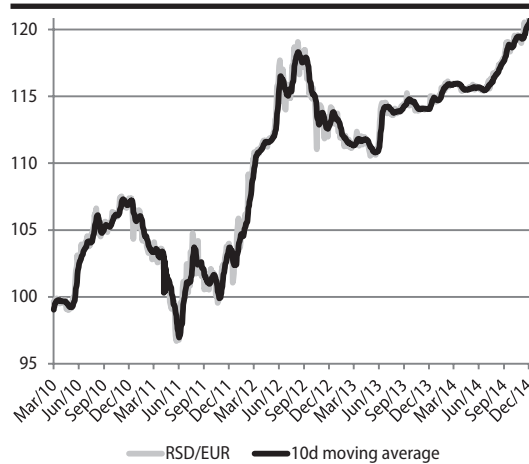


Chart T5-7. Nominal exchange rate depreciation (in %) in Period of July-October 2014 in Chosen Central and Eastern European Countries

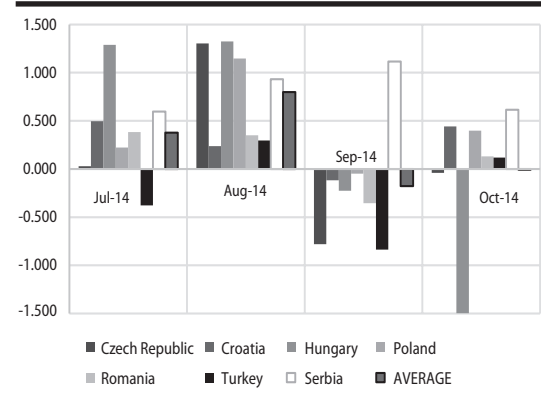
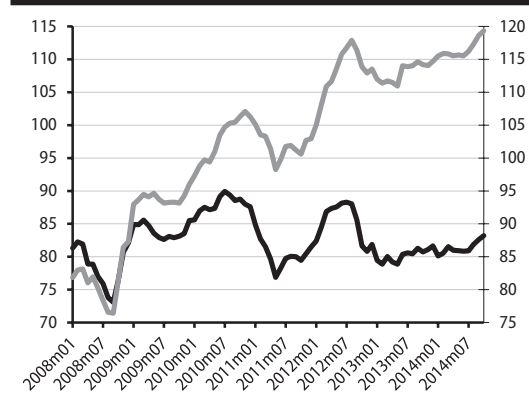


Chart T5-8. Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly Averages, 2008-2014



real dinar exchange rate during Q3 was mostly affected by the changes in the nominal exchange rate and to a lesser extent, the ratio of the domestic and euro zone inflation (while inflation in Serbia was 0.2%, in the euro area during the same period it amounted to -0.2%). Real exchange rate in the previous period (about two years back), was relatively stable, but since the beginning of Q3, a period of a moderate real depreciation began, and it could lead to the improvement of the economy competitiveness at an acceptable cost at the side of inflation (which is located below the lower limit of the target band) and loan servicing costs. Historically observed, the real dinar value at the end of the October was by 4% higher than in a first half of 2012, so the additional depreciation would be welcome in order to spur export as one of the main drivers of the growth in the coming years (Graph T5-8).

vement of the countries in the region (measured by the EMBI index) was relatively stable during Q3. At the end of Q3, EMBI index value for Serbia was increased by 32bp when compared to the late Q2, while the average level was higher only by 1bp when compared to an average of Q2. In addition to global factors which influenced the movement of EMBI index of the countries in the region, above-average index growth for Serbia occurred due to a poor assessment of the situation in the public finances by investors and rating agencies.

During Q3 there was real dinar depreciation by about 2.2% and 0.7% in October. Total real depreciation since the beginning of 2014 until the end of October was 1.9%. The movement of the