5. Prices and The Exchange Rate

In Q4, inflation continued to accelerate, and the year-on-year growth of consumer prices in Serbia in December 2022 was 15.1%. Average inflation last year was almost three times higher than in 2021 and amounted to 11.9%. Almost two-thirds of last year's increase in the price of the consumer basket comes from the rise in food and energy prices, which is why Serbia does not differ from other European countries. However, there are also essential differences - the contribution of food prices to overall inflation was noticeably higher than in CEE countries, while the impact of energy on inflationary trends was largely reduced thanks to the control of gas and electricity prices. However, such a policy achieved only temporary success in suppressing inflation, while its fiscal cost was huge - around 2.4 billion euros. After the autumn price increase of electricity and gas, there was a new price increase as of January 1st this year (and another one is planned for May), which means that the inflationary pressures due to the increase in energy costs have largely been postponed until 2023. Consequently, unlike other CEE countries where inflation has generally been falling for several months, in Serbia the growth in consumer prices continued at the beginning of this year, so that year-on-year inflation jumped to 16.1% in February. As of December 2022, core inflation (measured by CPI excluding food, energy, alcohol and tobacco) has been also in double digits, and in February it was 11.1%, which is its highest value in the last ten years. The high level and rising trend of core inflation indicate that inflationary pressures in the Serbian economy are still strong, despite the fact that since Q4 there have been clear indications of their easing in the international environment. In line with our expectations, the NBS continued to tighten monetary policy by increasing the key policy rate by 25 b.p. per month (to the current 5.75%), and current trends suggest that the monetary adjustment cycle will most likely end after one or two more hikes in the key policy rate. In Q2 2023, we expect a reversal of the rising year-on-year inflation trend due to the easing of global cost pressures, the weakening of domestic demand on several grounds (more restrictive monetary policy, high inflation devaluing the sources of financing domestic consumption, etc.) and the effect of last year's high base. Inflation from December of last year to December of this year could be around 10%, while average inflation in 2023 will most likely be close to last year's level (around 12%). Thanks to the extensive interventions of the NBS, the nominal exchange rate of the dinar against the euro remained stable throughout 2022 (slight appreciation by 0.2%) despite major turbulence on the foreign exchange market. In order to prevent greater fluctuations in the exchange rate, the NBS last year net bought 1 billion EUR on the interbank foreign exchange market. A stable nominal exchange rate together with high domestic inflation caused a real appreciation of the dinar by 8.3% in the past year, which adversely affects the price competitiveness of the Serbian economy.

Prices

Strong and widespread growth in consumer prices was one of the main macroeconomic trends that marked the year 2022

Serbia ended the previous year with inflation of 15.1%, which represented the highest increase in consumer prices on an annual basis since 2005. Year-on-year inflation accelerated month by month and at the end of the year was almost twice as high as in December 2021 (Table T5-1). As a result, average inflation also jumped sharply and was almost three times higher than in 2021 – 11.9% in 2022 versus 4.1% in 2021. Along with the acceleration of overall inflation, the prices of a number of products and services increased significantly, so that by the end of 2022, the increase in consumer prices in the domestic economy became widespread. Namely, according to December data, as many as 85% of products and services that make up the average consumer basket in Serbia went up in price by more than 4.5%, i.e., from the upper limit of the NBS target interval. The highest price growth in 2022 was recorded in food and non-alcoholic beverages (23.4%), followed by services related to housing (renting apartments, utilities, electricity and heating), which rose in price by 19.3%, and equipment for the apartment and ongoing maintenance

Table T5-1. Consumer price index and inflation, 2018-2023.

	Consumer Price Index				
	Base index (avg. 2006 =100)	Y-o-y growth	Cumulative index	Monthly growth	Quarterly growth
2018					
dec	195.0	2.0	2.0	0.1	-
2019					
dec	198.6	1.8	1.8	0.5	0.1
2020					
dec	201.1	1.3	1.3	0.0	-0.2
2021					
mar	204.3	1.8	1.6	0.5	1.1
jun	208.1	3.3	3.5	0.3	2.0
sep	212.1	5.7	5.5	0.8	1.5
dec	216.9	7.9	7.9	0.4	2.5
2022					
jan	218.7	8.3	0.8	0.8	-
feb	221.1	8.8	1.9	1.1	-
mar	222.9	9.1	2.8	0.8	2.4
apr	226.3	9.6	4.3	1.5	-
may	229.1	10.4	5.6	1.2	-
jun	232.8	11.9	7.3	1.6	3.8
jul	235.2	12.8	8.4	1.0	
aug	238.1	13.2	9.8	1.2	-
sep	241.7	14.0	11.4	1.5	3.9
oct	246.2	15.0	13.5	1.9	-
nov	248.6	15.1	14.6	1.0	-
dec	249.7	15.1	15.1	0.4	4.1
2023					
jan	253.2	15.8	1.4	1.4	-
feb	256.7	16.1	2.8	1.4	-

Note: Quarterly growth is the rate of inflation in the current quarter compared to the average of the previous quarter.
Source: SORS and *QM* estimate.

(18.2%). When looking at the structure of last year's consumer price growth, almost two-thirds (about 65%) can be attributed to food price increases (7.3 p.p. contribution) and energy (2.6 p.p. contribution). However, the contribution of the prices of other products and services to total inflation also gradually increased - from slightly over 20% at the end of 2021 to around 35% in December last year. The fact that inflation spread to an increasing number of products during 2022 is confirmed by the movement of base inflation (measured by the consumer price index excluding food, energy, alcohol and tobacco products), which also reached the zone of double-digit growth rates. In December, base inflation was 10.1%, which is its highest value in the last ten years.

Last year's high inflation was largely imported, although at least a third of the increase in consumer prices in Serbia can be attributed to domestic factors

The acceleration of inflation in 2022 is a global phenomenon and a challenge that even the most economically developed countries are currently facing. World inflation is the result of the combined influence of demand- and supply-side factors. Strong monetary and fiscal expansion contributed to incomes growing faster than production, which influenced the formation of an imbalance between supply and demand. Leading central banks have conducted strong monetary expansion practically since the Great Financial Crisis, only to intensify it further with the onset of the COVID-19 pandemic. With the onset of the COVID-19 pandemic, almost all countries applied fiscal incentives that encouraged a faster growth in the incomes of citizens and economy than the growth of production, which further increased the difference between supply and demand. In the conditions of the imbalance between supply and demand, the trigger for a strong increase in prices at the world level was a series of shocks on the supply side caused first by the COVID-19 pandemic, and then by the war in Ukraine: stoppages in supply chains, the growth of transport costs, the energy crisis, the growth of international food and other raw materials prices, etc.

These global factors were inevitably reflected in domestic cost pressures and the recorded price growth during 2022 had a very pronounced import component. Their unfavorable influence on the trend of inflation in Serbia was actually somewhat muted compared to other CEE countries, primarily thanks to the price control of the main energy sources - electricity and gas. Since inflation in the CEE countries also included a strong increase in their prices, the contribution of energy to the total inflation in the Region was 2-3 times higher than in Serbia during the previous year. This is also the main reason why year-on-year inflation in December 2022 in Serbia was over 2 percentage points lower than the average in Central Europe (15.1% versus 17.2%). However, the fiscal cost of such a pricing policy on the domestic market of electricity and gas was huge - by the end of last year it had grown to 2.4 billion euros, and new costs are being planned in 2023, despite the fact that in the meantime a phased increase in energy prices has begun .

In other words, if Serbia implemented a similar pricing policy for electricity and gas as CEE countries, domestic inflation would be slightly higher than the average in the region, which suggests that there are domestic factors that contributed to the strong growth of consumer prices in 2022. A similar assessment applies to the international environment. Namely, there is already enough evidence that the record high inflation in many countries is not only the result of shocks on the supply side, but that economic policy measures also contributed to it. This applies to the monetary expansion before and during the pandemic, the excessively expansive fiscal policy since the beginning of the pandemic, but also to the delayed response of the monetary authorities due to the initially mistaken belief that the acceleration of inflation is solely the result of temporary disruptions on the supply side that central banks cannot influence.

Serbia was no exception in terms of the mix of economic policies it implemented from the point of view of their contribution to the trend of inflation in 2022. Anti-crisis fiscal measures since the beginning of the COVID-19 pandemic reached 5.4 billion euros (10.4% of GDP), which in relative terms was more than 50% in relation to comparable countries of Central and Eastern Europe. Another important difference compared to the countries of the region was the very generous and often completely indiscriminate subsidies to the population, which by the end of 2022 reached the amount of almost 2 billion euros (about 4% of GDP), which was almost entirely transferred to consumption. On the monetary policy side, the NBS started to increase the key policy rate from April 2022 – a few months after other central banks in the CEE region. Taking all that into account, we estimate that at least a third of the growth in consumer prices in 2022 in Serbia (5-6 percentage points) is the result of the inflationary effect of domestic economic policies.[1]

In Q4 2022, inflation was relatively high, but year-on-year inflation was slowing down

In Q4 2022, prices rose by 4.1% compared to the average of the previous quarter, which was the highest quarterly inflation rate in the past year (Table T5-1). On a monthly basis, prices rose the most in October (1.9%), while November and December inflation were noticeably lower, 1% and 0.4%, respectively. The slowdown of monthly inflation and the effect of the high base from 2021 contributed to the year-on-year inflation temporarily stabilizing, so that in the last two months of 2022 it remained unchanged and amounted to 15.1%. During the last three months of 2022, the average consumer basket rose in price by 3.3% (Table T5-2). More than half of this increase comes from the rise in prices of food and non-alcoholic beverages, the prices of which increased by 5.8% on average (contribution of 1.8 p.p.). Within this group, the prices of milk, cheese and

Table T5-2. Selected components of the consumer price index and contribution to inflation growth

	Share in CPI (in %)	price increase in Q4 2022.	Contribution to overall CPI increase (in p.p.)	price increase in January 2023.	Contribution to overall CPI increase (in p.p.)	price increase in February 2023.	Contribution to overall CPI increase (in p.p.)
Total	100.0	3.3	3.3	1.4	1.4	1.4	1.4
Food and non-alcoholic beverages	31.4	5.8	1.8	1.6	0.5	2.7	0.8
Food	27.8	6.0	1.7	1.7	0.5	2.8	0.8
Alcoholic beverages and tobacco	7.1	1.3	0.1	2.5	0.2	0.3	0.0
Tobacco	4.4	0.0	0.0	4.1	0.2	-1.1	0.0
Clothing and footwear	4.5	4.2	0.2	0.0	0.0	-0.6	0.0
Housing, water, electricity and other fuels	13.6	3.9	0.5	3.5	0.5	1.0	0.1
Electricity	5.1	0.0	0.0	7.1	0.4	0.0	0.0
Furniture, household equipment, routine maintenance	4.3	5.4	0.2	1.2	0.1	0.9	0.0
Health	5.5	1.0	0.1	0.2	0.0	1.2	0.1
Transport	12.6	-1.7	-0.2	-0.6	-0.1	0.8	0.1
Oil products	6.2	-5.3	-0.3	-2.3	-0.1	1.5	0.0
Communications	5.7	0.3	0.0	0.1	0.0	0.1	0.0
Other items	15.4		0.5		0.2		0.1

Source: SORS and QM estimate.

1 In the IMF working paper (Minasyan, G., E. Ozturk, M. Pinat, M. Wang, Z. Zhu, 2023. Inflation Dynamics in the Western Balkans. IMF Working Paper no. WP/23/49), it is estimated that domestic policies, which encourage demand growth, significantly influenced inflation in the countries of the Western Balkans.

eggs increased the most (16.8%), with a contribution to inflation of 0.8 percentage points. In Q4, for the first time in the last year, the prices of energy had a neutral effect on the trend of overall inflation - the contribution of the increase in the price of firewood and coal and district heating services of 0.3 p.p. was neutralized by the drop in fuel prices for passenger vehicles by 5.3% (contribution of 0.3 p.p.). However, the price growth of other products and services slightly accelerated compared to the previous quarter, making a cumulative contribution to inflation of 1.5 p.p. Observed by individual groups, the highest price increases were seen in equipment for the apartment and current maintenance (growth of 5.4%, contribution of 0.2 p.p.), clothing and footwear (growth of 4.2%, contribution of 0.2 p.p.) and some services (e.g. catering services, renting apartments, etc.).

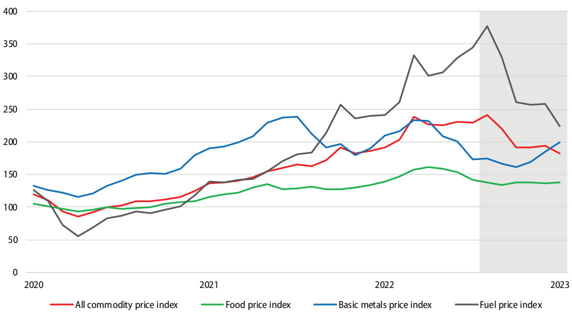
The beginning of 2023 brought a new acceleration of inflation, due to the additional increase in food prices and the January increase in electricity and gas prices

January 2023 recorded relatively high inflation of 1.4%, although this was expected due to the previously announced increase in electricity and gas prices for households. Namely, since January 1st, electricity has been more expensive on average by 8% and gas by 11%, which contributed to inflation in that month by over 0.4 p.p. The 1.6% increase in the prices of food and non-alcoholic beverages contributed to January inflation by almost 0.5 percentage points, while the increase in the price of tobacco products by 4.1% contributed by 0.2 p.p. (Table T5-2). The only significant disinflationary factor in January was the drop in fuel prices for passenger vehicles by 2.3% (contribution -0.1 p.p.) as a result of the downward trend in world oil prices from the previous few months. February inflation also amounted to 1.4% primarily due to the increase in food prices by 2.7% (contribution of 0.8 p.p.), of which the prices of fresh vegetables, bread and cereals increased the most (cumulative contribution of almost 0.6 p.p.). Observed by year-on-year, price growth within this group reached a record 24.6% with an increase in contribution to total inflation to 7.7 p.p. After temporary stabilization of interannual inflation at the end of last year, its new maximum of 16.1% was reached in February. This is slightly higher than the expectations of the NBS and central projection presented in February inflation report, which predicted that the year-on-year price increase in Q1 2023 would amount to 15.6%.

The last quarter of 2022 and the beginning of this year was marked by an easing of global inflationary pressures

After more than two years of continuous strengthening of cost pressures in the international environment, from the fall of 2022 we are seeing a reversal of this trend. The prices of raw materials on the international market, measured by the IMF's composite index, fell by about 25% in the period from September 2022 to January this year (Graph T5-3), with a particularly deep drop in the prices of energy products (on average by about 40%). World oil prices returned to the level of the period immediately before the outbreak of the war in Ukraine, which was a shock that strongly pushed them upwards from March 2022. The sharp drop in gas prices on European stock exchanges by over 60% compared to August last year was particularly important for Serbia. World food prices in January 2023 were about 15% below their maximum level in the last year, although they are still noticeably above the multi-year average from the pre-crisis period. Among the most important raw materials, only the prices of base metals recorded a jump during autumn and winter, which is mainly a consequence of the opening and recovery of the Chinese economy. Supply chain bottlenecks have also been cleared over the past year, and according to February data, the value of the Global Supply Chain Pressures Index (GSCPI) has dropped to its historical average. All of these are signals that show that the impact of cost pressures in the international environment on inflation trends has already begun to weaken.

Graph T5-3: The main price indices on world commodity markets, 2020-2023

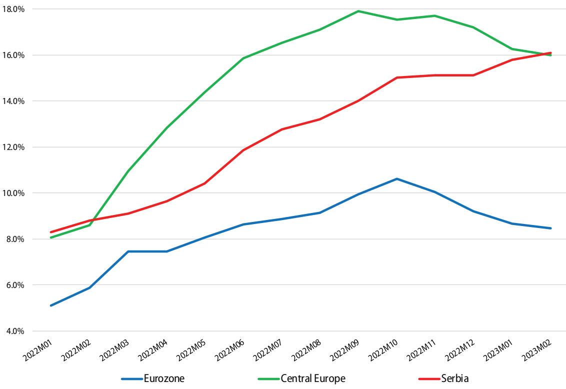


Source: IMF Primary Commodity Prices

Inflation in the international environment has not yet been brought under control, but in many countries it has started to decline in 2022

The weakening of cost pressures on the supply side, as well as the effects of the previous tightening of monetary policy on easing inflationary pressures on the demand side, contributed to inflation being on a downward path in many countries in 2022.

Grafikon T5-4. Year-on-year inflation in the Eurozone, Central Europe and Serbia



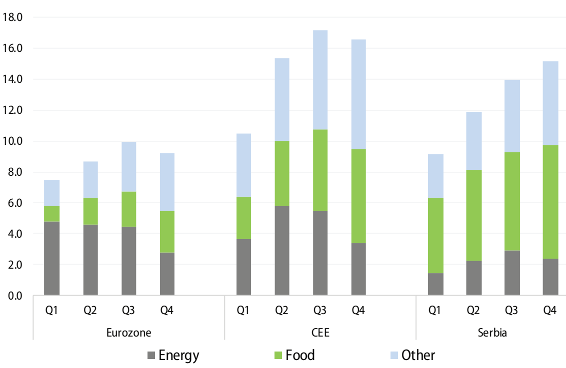
Source: Eurostat and QM estimate.
Note: Central Europe does not include the three Baltic countries (Estonia, Latvia and Lithuania) and therefore represents a narrower set of countries compared to CEE.

In the US, inflation reached a record 9.1% in June last year (the highest level since the beginning of the 1980s), but since then it has been constantly decreasing to 6%, which was its amount in February 2023. In the Eurozone, inflation reached its maximum a little later - in October 2022, it was 10.6% (Graph T5-4) which was the highest level since the establishment of the monetary union. In the next few months, year-on-year inflation in the EC decreased and, according to the latest data, amounts to 8.5%. In the countries of Central Europe, the growth of consumer prices was more pronounced than in the rest of the EU, and there are quite large differences when looking at individual countries. For example. in Hungary, annual inflation is currently above 25%, while in Slovenia it is below 10% and in Croatia it is around 12%. However, if we look at the average of the countries in the region, we first see a clear tendency of inflation acceleration until September 2022, when it reached a maximum of 18%, and then a slight but steady trend of its slowdown to the level of 16% in February this year. As can be seen in Graph T5-4, immediately after the outbreak of the war in Ukraine, inflation in Central Europe accelerated significantly more than in Serbia and was higher throughout the last year, but in the first two months of 2023, domestic inflation reached the average of the region.

The acceleration of inflation in Serbia was delayed compared to the CEE countries due to the delayed increase in energy prices, but that is why its slowdown will begin several months later.

As can be seen in Graph T5-5, the contribution of food and energy prices to overall inflation in 2022 was quite high across Europe, amounting to around 70%. However, in Serbia, two important differences can be observed in the structure of last year's price growth compared to other European countries. First of all, the contribution of energy prices to total inflation in the Eurozone and CEE in the first half of 2022 was 2-3 times higher than in Serbia. The reason is that the retail prices of electricity and gas in European countries somewhat followed the strong growth of stock market prices, while in Serbia they remained frozen at the pre-crisis level. Stabilization in the European energy market enabled a gradual decline in retail electricity and gas prices, which is seen as a rather sharp reduction in the contribution of energy to overall inflation in the Eurozone and CEE in Q4. In Serbia, we have the opposite situation - the cycle of price increases for these energy products started in Q3, continued in January, and a new price increase was announced as of May 2023. Therefore, the control of gas and electricity prices eased domestic inflationary pressures in 2022, but only temporarily, because their delayed price increase will generate cost pressures at least until the second quarter of the current year (unlike other CEE countries). As a result, it is expected that the slowdown in year-on-year inflation in Serbia in 2023 will start later and be slower than in the countries of the region. Another specific feature of inflation in Serbia is the significantly higher contribution of food prices compared to the Eurozone and CEE. This is primarily a consequence of the much larger share of food in the average consumer basket, which in Serbia amounts to over 30%, while in the Eurozone food participates with around 16% and in CEE with around 23%.

Graph T5-5: Contributions to inflation in the Eurozone, CEE and Serbia, Q1 2022 - Q4 2022

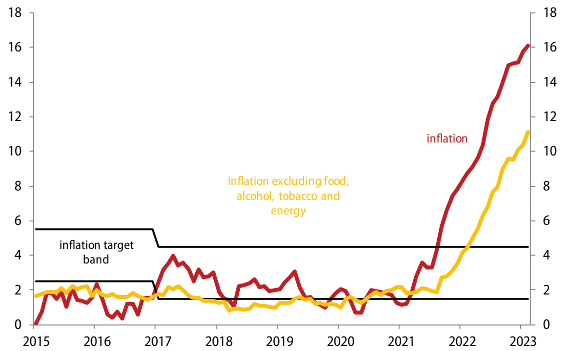


Source: Eurostat, SORS and QM estimate.

During Q4, core inflation moved into the zone of double-digit growth rates, and in February 2023 it amounted to 11.1%

The common pattern of last year's inflation in all European countries is a constant increase in the contribution of prices of other products to total inflation (Graph T5-5). Serbia was no exception either - core inflation (measured by the consumer price index excluding food, energy, alcohol and tobacco) followed the acceleration of year-on-year inflation and, according to data for February 2023, reached a high 11.1% (Graph T5-6). The contribution of prices included in the calculation of core inflation to the total inflation increased from less than 2 p.p. in January 2022 to 5.2 p.p. in February 2023. The value of this indicator of inflationary pressures strength in Serbia is still somewhat lower than in the CEE countries (close to 13%), but this difference has been decreasing in the last few months. The high level and rising trend of core inflation indicate the presence of strong inflationary pressures in the Serbian economy, but also that there are no clear signs of their easing yet (in contrast to the Czech Republic and the Baltic countries, where core inflation is already on a downward trend). The delay in core inflation in Serbia compared to countries in the region can be partly linked to the control of electricity and gas prices for companies. This eased the cost pressures in the domestic economy last year, but since the correction of the prices of these energy sources has started in the meantime, inflationary pressures due to the increase in energy costs will be felt in 2023. By maintaining a stable exchange rate of the dinar against the euro, the NBS also contributed to the easing of inflationary pressures, because this limited a spillover of high import inflation to the domestic market. When conducting monetary policy, central banks pay the most attention to the movement of core inflation, due to the increased volatility of food and energy prices - often because of supply-side shocks that the monetary authorities cannot influence much. However, in Serbia, the high price growth of food products over the past year has a proportionately greater influence on the creation of inflationary expectations due to their greater weighting in the consumer basket compared to CEE countries.

Graph T5-6. Year-on-year rate, underlying inflation and NBS target corridor, 2015-23

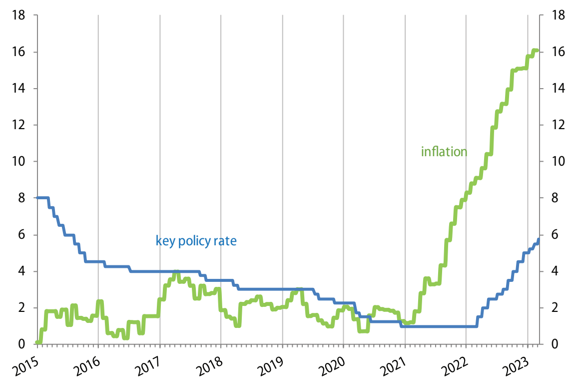


Source: Eurostat, SORS and QM estimate.

The NBS continued to increase the key policy rate in 2023 by 25 basis points per month, and in March 2023 it amounts to 5.75%

In the first months of 2023, the NBS continued to tighten the monetary policy, and in accordance with the expectations presented in the previous issue of QM, the trend of raising the key policy rate was reduced from 50 to 25 basis points per month. The cycle of increasing the restrictiveness of monetary policy has now lasted for a full year, during which the key policy rate was increased by 4.75 percentage points - from 1% in April 2022 to the current 5.75% (Graph T5-7). At the end of last year, there were expectations that the NBS could end raising the key policy rate during Q1 2023, since a reversal of the rising trend of annual inflation was predicted at the beginning of Q2. However, now it is no longer so certain and we do not rule out the possibility of one or two more increases in key policy rate by 25 basis points. This is supported by the fact that the year-on-year inflation slowdown in Serbia could be somewhat slower than expected, as well as the fact that core inflation still shows no signs of slowing down, which would clearly indicate a weakening of inflationary pressures in domestic economy. A similar assessment applies to monetary policy in international environment, with the exception of central banks in CEE, which most likely have already ended the cycle of monetary policy tightening. Namely, despite the growing concern about problems in certain banks in the US and Europe, the

Graph T5-7. NBS key policy rate and year-on-year inflation rate, in %, 2015-23



Source: NBS

Trends

ECB again increased the key policy rate by 50 basis points in March, and a similar decision is expected from the FED (albeit, probably by 25 basis points). Currently, the prevailing view is that persistently high inflation is a much greater risk to the world economy than individual problems in the financial sector, that is, that leading central banks should continue to tighten financial conditions until inflation is firmly under control.

Year-on-year inflation will begin to gradually slow down from Q2 2023, and we expect it be around 10% at the end of the year

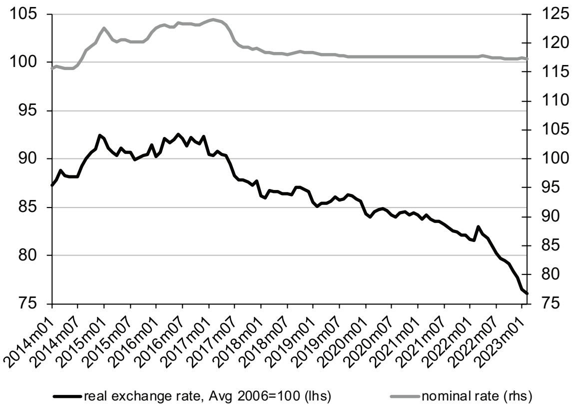
Year-on-year inflation should reach its maximum in March (about 16.5%), after which we expect its gradual slowdown in Q2 and in the second half of 2023. The declining trend of overall inflation will be contributed by the weakening of global cost pressures and lower import inflation, the fact that high inflation has already significantly reduced the real value of income finances domestic demand (salaries and pensions), as well as an increase in the restrictiveness of monetary policy, which will also contribute to the weakening of pressures from the demand side and favorably affect inflationary expectations in the Serbian economy. On the other hand, there are cost pressures whose effect in Serbia has been postponed from 2022 to this year (the increase in energy prices was mentioned, some other price increases such as postal services, etc. were announced) which will act in the opposite direction and partially neutralize the effect of last year's high bases. The movement of year-on-year inflation will largely depend on the upcoming agricultural season, as prices of fruit, vegetables and other food products were unusually high in 2022 due to the drought. A good agricultural season could therefore be a significant disinflationary factor that would accelerate the decline in year-on-year inflation by the end of the year. According to the central NBS projection from the February Inflation Report, inflation should drop to 7.5% by the end of 2023. However, there are reasons why this forecast could turn out to be too optimistic. First of all, the peak point from which the year-on-year inflation will start to slow down will be by about 1 p.p. above the NBS estimate at the time. We also expect that the trend of its slowdown will be milder, because inflationary pressures in the domestic environment are apparently somewhat stronger than the assumptions on which the official February inflation projection was based. According to our estimates, year-on-year inflation should definitely return to the single-digit zone in Q4, closer to 10% in December 2023. This will also push average inflation in 2023 higher compared to the initial projections of the NBS, and we estimate that it will remain close to last year's level (12%).

The Exchange Rate

Despite great turbulence on the foreign exchange market since the beginning of 2022, the exchange rate of the dinar against the euro has remained stable thanks to extensive interventions by the NBS

The beginning of 2022 was marked by strong depreciation pressures on the dinar due to the high demand for foreign exchange to finance the import of expensive energy products, and then due to the withdrawal of foreign investors immediately after the outbreak of the war in Ukraine. However, the situation has completely turned around since May last year, when appreciation pressures on the domestic currency began to prevail, and this is a trend that is still ongoing. In order to prevent major fluctuations in the exchange rate, the NBS was very active on the interbank foreign exchange market (IFEM) - first on the selling side of foreign exchange in Q1 2022, and then mainly as a buyer of foreign exchange. Looking at the whole year, the NBS bought 1 billion euros net in order to prevent a significant strengthening of the dinar against the euro. During 2022, the dinar nominally strengthened against the euro by 0.2%, from 117.6 to 117.3 dinars per euro, and it maintained the same value in the first two months of 2023 (Graph T5-8). Among the more important sources of the increase in

Graph T5-8. Nominal and real dinar/euro exchange rate, monthly average, 2014-2023.



Source: NBS, SORS, Eurostat and *QM* estimate.
Note: Increase represents depreciation of the excange rate.

supply of foreign exchange and consequently appreciation pressures on the dinar in the past year, we single out the record-breaking inflow of FDI (4.4 billion EUR), and in the past few months we have also recorded significant state borrowing abroad (a loan from the UAE of 1 billion USD, approved funds within the framework of the credit arrangement with the IMF and the issuance of two government bonds worth 1.75 billion dollars). When compared to the US dollar, the dinar weakened by 6% last year, as a result of strengthening of the US currency against the euro. This adversely affects the level of public debt denominated in dollars (currently around 14% of the total debt of the general government), and the import of some goods that are traditionally paid for in dollars (such as oil and gas) becomes more expensive.

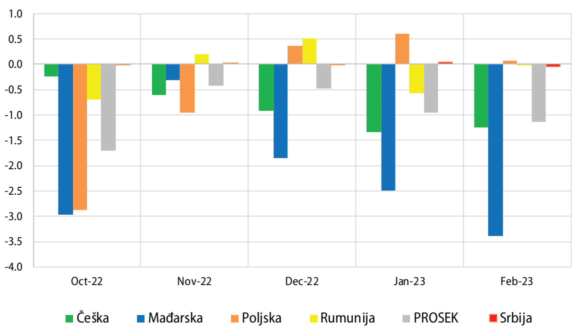
The real exchange rate of the dinar kept strengthening, as a consequence of the stable nominal exchange rate against the euro and high domestic inflation

Maintaining the nominal exchange rate of the dinar against the euro is currently a good policy in many ways – it limits the spillover of high import inflation to the domestic market, has a favorable effect on inflationary expectations, and is also important for the stability of the entire financial system in highly euroized countries such as Serbia. However, such a policy also has a less favorable consequence in conditions of very high domestic inflation, which is reflected in a powerful real dinar strengthening in relation to the euro. As can be seen in Graph T5-8, that trend has become particularly pronounced since March 2022 (which coincides with the acceleration of domestic inflation), and as of February this year, the dinar has already strengthened in real terms by 8.3%. Bearing in mind the short-term projections of inflation in Serbia and the Eurozone, as well as the determination of the NBS to keep the dinar exchange rate stable, the trend of real appreciation of the domestic currency will last for the next few quarters. In the medium term, this will have a negative impact on the price competitiveness of the export part of Serbian economy.

In Q4 2022 and at the beginning of this year, appreciation pressures also prevailed in other CEE countries with a similar exchange rate regime

The currencies of all CEE countries with a similar exchange rate regime strengthened significantly in the last quarter of 2022 and first two months of this year (Graph T5-9). There are several common factors that explain such a trend in foreign exchange markets in the region, the most important of which are the tightening of monetary policy in the previous period, drop in energy prices and improvement in the balance of payments. Over the past five months, the Hungarian forint has strengthened nominally against the euro the most (10.5%), followed by the Czech crown (4.3%) and the Polish zloty (2.8%). The Romanian lev strengthened slightly against the euro (0.5%), mainly thanks to more extensive interventions by the Romanian central bank on the foreign exchange market. During the current episode of high inflation, most central banks in CEE increased the volume of interventions in foreign exchange markets, albeit to a lesser extent than the NBS does. As a result, for several years now (as shown in Graph T5-9), the dinar exchange rate fluctuations against the euro have been incomparably less pronounced than in other currencies in the region.

Graph T5-9. Nominal exchange rate change (in %) in selected CEE countries



Source: Eurostat
Note: Increase represents depreciation of the exchange rate.