

5. Prices and the exchange rate

In Q2 and July inflation ranged below the lower limit of the NBS target band and at the end of July it stood at 2%. The growth in the prices of food lower than expected (largely due to a drop in the prices of unprocessed food that has affected the prices of processed food), as well as a low domestic demand were the main contribution to a low inflation until the end of Q2. July recorded weak inflation, which was largely affected by the fall in the prices of raw material in the food industry, although there was a mild dinar exchange rate depreciation which mostly affects the growth in the underlying inflation (which excludes the prices of food, energy, alcohol and tobacco). By the end of the year it is expected that the inflation will return within the target band, largely due to a low base effect from the previous year. There will be no significant changes in inflation, since it is expected that the factors influencing the inflation change the most will be under control. The exchange rate, as one of the most influential factors, already depreciated (in July and August) but we estimate that the NBS will not allow it to change to a greater extent, given that in the past it showed willingness to intervene considerably in order to prevent greater depreciation of the exchange rate. Another significant factor that will affect the stability of inflation is a low domestic demand, the reduction of which is expected in the following period as a result of fiscal consolidation measures (reduction in salaries and pensions in the public sector). Entering into recession will also have a disinflationary effect. The dinar exchange rate movement during Q2 and July and August is to a large extent influenced by global factors, although throughout the entire period the dinar exchange rate depreciated significantly more than the currencies of other countries in the region with similar exchange rate regimes. The growth in investors' distrust in the Government's economic policy has significantly contributed to the weakening of the dinar. Real depreciation in July and August annulled the appreciation from the beginning of the year and such moderate dinar depreciation affects the improvement of the competitiveness of the economy with the acceptable costs at the inflation side (which is already low) and the costs of credit servicing.

Prices

Inflation extremely low and in Q2 and July ranges below the lower limit of the NBS target band

From the beginning of the year y-o-y inflation has been at a low level, and since March it fell below the lower limit of the NBS target band, where it continued to move throughout Q2 and in July (Table T5-1). Relatively long period of low inflation for the situation in Serbia was followed by a lowest year-on-year inflation (1.2%) over the past five decades recorded in June. Price growth in Q2 is lower than expected (mostly because of a low growth in the prices of unprocessed food), while July was marked by weak deflation (due to a fall in the prices of unprocessed food, especially vegetables). A contribution to a low inflation was made by the lack of higher pressures in production, low aggregate demand, the decline in inflationary expectation and a relative stability of the dinar exchange rate (until July), low imported inflation, as well as a slow mitigation of monetary policy restrictiveness (key interest rate is relatively high 8.5%). For the same period, from May to July, underlying inflation (measured by the consumer price index excluding the prices of food, alcohol, tobacco and energy) revolved around lower limit of the NBS target band, with occasional egresses below the limit value, where it is currently located (data for July). Underlying inflation is also at the lowest level for a long period of time (Graph T5-2). The return of year-on-year inflation within the limits of the target band is expected in Q4, when the disinflationary pressures on food prices should disappear, although a low aggregate demand will remain the main disinflationary factor. Dinar depreciation as well as a possible increase in the prices of energy (gas and electricity) will affect the growth of inflation with a lag of 1-2 months. The period with relatively high values of monthly inflation lasted until Jun, whereas from July to December an average monthly inflation was negative and amounted to -0.1%. A slowdown in economic activity will have a disinflationary effect, while the measures of fiscal adjustment will

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
maj	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

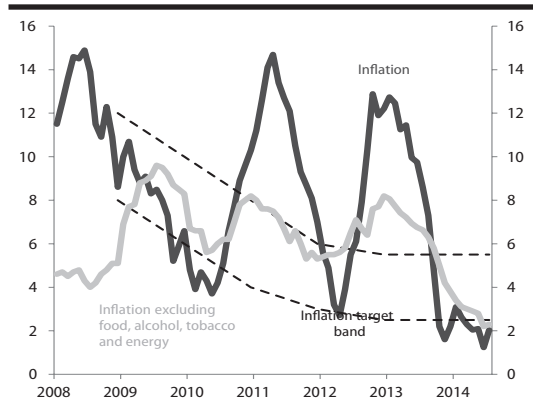
* Three-month moving average of a price growth rose to an annual level. (For example, the March value is obtained by raising the average monthly price growth in January, February and March to an annual level).
Source: SORS

additionally affect the aggregate demand reduction and price stability; it is expected that July and August dinar depreciation will have inflationary effect in the following period. Significant changes in inflation are not expected to occur by the end of the year. Factors that could affect the changes in the price growth rate to a largest extent are: the exchange rate, which already depreciated, but in the previous period National Bank of Serbia showed the willingness to “defend” the exchange rate from the excessive deviation, even at the cost of considerable reduction in foreign exchange reserves; second factor that largely affects the inflation is the reduction in domestic demand, which is likely to occur due to anticipated cuts in wages and pensions (fiscal consolidation measures).

The gradual restrictiveness mitigation of the monetary policy by the NBS

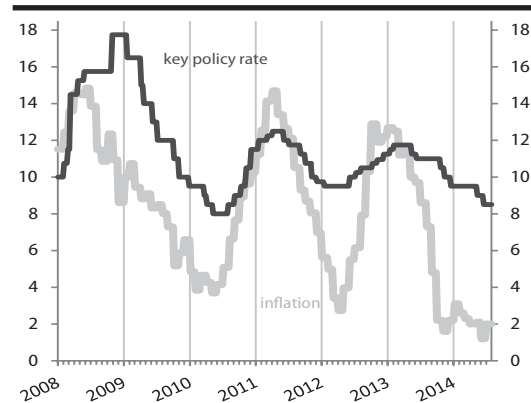
The measures of the National Bank of Serbia were not synchronized with inflation movement to the best extent in the past year. Since the inflation returned within the limits of the target band in September 2013, there was a modest reduction in the key interest rate, from a high level of 11%, which in previous years corresponded to the periods with inflation of over 10% (Graph T5-3) to a still high 8.5% in June 2014, even though the inflation is at a record low level, with no prospects for a significant growth, and the economy is stagnant or on the verge of recession. During Q2, there were two reductions in key interest rate by 50 basis points at the meetings of the NBS’ Executive Board in May and June (to 9% and 8.5% respectively). The current account deficit is stabilized at a high level of around 5%, and the strengthening of the real dinar value has certainly contributed to a slowdown of the export growth and acceleration of the import

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



Source: NBS and QM estimates

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



Source: NBS

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growth. The explanation for the implementation of more restrictive monetary policy than the one more suitable to the conditions of a current low inflation could be found in the structural imbalances in the economy of Serbia (high fiscal and foreign-trade deficit, high level of bad loans in economy) that can threaten macroeconomic stability. The indecisiveness of the Government to implement stricter measures of fiscal consolidations and the delay of the announced measures causes a distrust of investors which is primarily expressed in the foreign exchange market, only to later transfer to inflation as well.

Low inflation in Q2 and deflation in July 2014

Overall inflation in Q2 and July amounted to 0.6% (individually: 0.8% in Q2 and -0.1% in July). Observed from the beginning of the year- after a one-off inflation increase in January (conditional seasonal increase in the prices of food and an increase in specific VAT rate and excise duties), there was a period of a low monthly inflation in Q1 and Q2, as well as the occasional low deflation- in March and July (Table T5-1). Inflation in Q2 was mostly contributed by the price growth of food (growth of 1.5%, i.e. contribution of 0.5pp) and telecommunication services (growth of 0.1%. i.e. contribution of 0.1pp) (Table T5-4), and in April the decline in the prices of food (-1.8%, i.e. contribution -0,6pp) and the increase in the fuel prices (1.2%, the contribution of 0.1pp). Unprocessed food prices increased in Q2 by 4.9%, out of which prices of fruit contributed the inflation by 0.4 pp, and the prices of fresh meat by 0.3%. Due to a good agricultural season in the country and abroad, seasonally expected increase in the prices of vegetables was absent, and its price continued to drop during July. Processed food prices, due to a fall in the prices of raw material, were in a decline in Q2 (all product categories except for milk and dairy products), and similar trend continued in July. The growth in the prices of industrial products excluding food and energy in Q2 did not occur as a result of low aggregate demand. None of the price categories from this group made a significant contribution (positive or negative) to overall inflation in Q2 and July. Service prices in Q2 increased by 1.6%, whereas the largest contribution to overall inflation has come from the rise in prices of package tours and to a less extent, from the changes in the prices of housing and utility services and vocational services. Regulated prices increased by 0.2% in Q2 (housing and communal services and medicaments), and observed from year-on-year standpoint, the growth of these prices is slowing down month by month and is currently standing at around 10%. Since the beginning of the year these prices have increased by 3.2 % (a consequence of adjusting to a higher VAT rate and an increase in the excise duties), while the higher growth in this price group is expected in the second half of the year, primarily on the basis of the expected rise in the energy prices, which has already begun in July. Also, the impact of the increase in the prices of telecommunication services on

the inflation growth is expected the coming months (from September). Floods in May haven't largely contributed to the prices, which is a result of a low demand but also fall in the prices of primary agricultural products in the global market, which will condition the cost pressures in food production remain low until the end of the year. Possibility of duty-free imports of most agricultural products from the EU as of this year also reduces the pressures on the growth in the food price in terms of reduced supply in the domestic market.

Overall and underlying inflation are relatively low

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

	Share in CPI (in %)	price increase in Q2 2014	Contribution to overall CPI increase (in p.p.)	Price increase in July 2014	Contribution to overall CPI increase (in p.p.)
Total	100.0	0.7	0.7	-0.1	-0.1
Food and non-alcoholic beverages	34.5	1.5	0.5	-1.6	-0.6
Food	30.9	1.7	0.5	-1.8	-0.6
Alcoholic beverages and tobacco	7.8	-0.2	0.0	-0.2	0.0
Tobacco	4.2	0.0	0.0	0.0	0.0
Clothing and footwear	4.6	0.4	0.0	-0.7	0.0
Housing, water, electricity and other fuels	13.0	0.2	0.0	0.3	0.0
Electricity	5.1	0.0	0.0	0.0	0.0
Furniture, household equipment, routine maintenance	4.1	-0.6	0.0	-0.7	0.0
Health	6.4	0.7	0.0	-0.1	0.0
Transport	12.3	-0.4	0.0	0.8	0.1
Oil products	5.1	-1.0	0.0	1.2	0.1
Communications	5.0	1.3	0.1	-0.1	0.0
Other items	12.2		0.1		0.4

Source: SORS and QM estimates

Underlying inflation (inflation excluding food, alcohol, tobacco, and energy) has been at a stable low level since the beginning of the year. Its slight growth was recorded in July 2014, when the three-month average was 1.2%, i.e. 4.9% when annualized (Graph T5-5). This leap is caused by the July's one-off increase in the prices of insurance and the prices of services from the group of recreations and culture (which doesn't need to be a one-off character). Overall inflation was slightly lower, since the growth of the prices in the group of products that are included into measuring the underlying inflation was offset by the fall in the prices of food and not too excessive an energy growth, thus annualized three-months average of the overall inflation amounted to a mere 0.2%. The growth of underlying inflation was affected by the unstable dinar exchange rate (July depreciation that continued in August and September), while the fall of the country risk premium had a disinflationary effect in Q2 and July (measured by EMBI index; the decline in risk premium is related to the global trend- the decline occurred in other countries in the region as well). However, uncertainty regarding the scope and the beginning of the fiscal reforms could threaten the exchange rate stability and thus affect underlying and overall inflation.

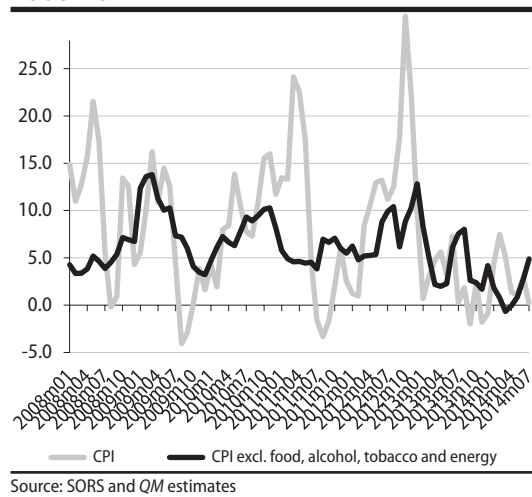
Moderate inflation increase and its return within the target band is expected by the end of the year

In Q3 year-on-year inflation will most likely stagnate and continue to move below the lower limit of the NBS target band. However, in the last quarter of the year 2014 we expect a moderate acceleration of inflation and its movement toward the center of the target band. The main drivers of the accelerating inflation will be dinar depreciation during the third quarter, and the prices of electricity and gas are expected to increase. The expected decrease of wages in public sector and pensions will impact the slowing down of inflation, thus the overall inflation in the fourth quarter will be relatively modest.

Entrepreneurs expect the inflation to reach the middle of the target band

Short-term inflationary expectations (in the next year) for the economy and financial sector are within the limits of the NBS target band, both in the short and medium term. Thus, the estimates of the inflationary expectations for the financial sector in the coming year range from 3.75% to 4.5%.

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



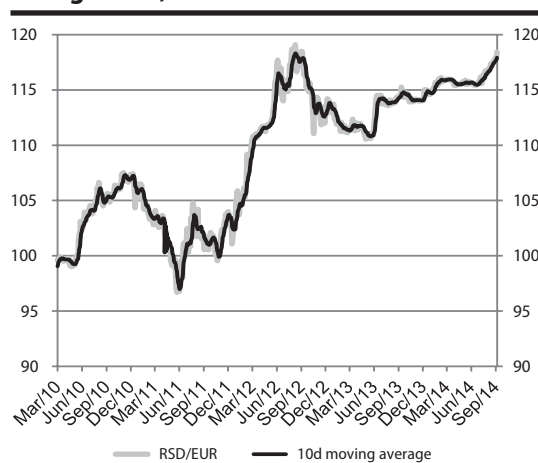
Inflationary expectations for the economy revolved around 5% in July. Expectations of the population are at a high 10%, but they are caused by the population's lack of information on the macroeconomic trends, and thus the current inflation rate, which is estimated to be at a high level of 10-15% as well (perceived inflation). Medium-term inflation expectation (for two years in advance) for the financial sector and economy are also within the limits of the NBS target band (4.6% and 6% respectively), while the expectations of the population are at the level of 10%. The biggest uncertainty in the estimates of the inflation trends in the following period refers to whether and in what amount will the price of the electricity and solid fuels be adjusted. There are risks to a less extent in the trends of agricultural product prices and regarding the current geopolitical tensions.

The exchange rate

Relatively stable dinar exchange rate in Q2, depreciation in July and August

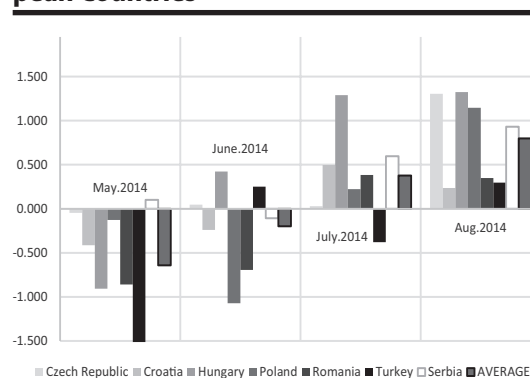
After a period of depreciation in January, the dinar exchange rate against the euro was relatively stable until the end of Q2. At the end of the period, dinar in Q2 nominally depreciated by 0.3%, while the average level rose slightly (0.2%) when compared to Q1. In July and August, however, there was a period of dinar depreciation which continued in the early September. From the level of less than 115 dinars per euro at the beginning of the year, the exchange rate moved around 119 dinars per euro in the early September (Graph T5-6). During Q2 the exchange rate was mostly stable with moderate appreciation pressures, which is consistent with the trend in the countries of

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



Source: NBS

Graph T5-7. Nominal exchange rate depreciation (in %) in Period of May-August 2014 in Chosen Central and Eastern European Countries



Source: Eurostat, NBS, QM estimates

the region that implement the fiscal exchange rate regime. To a large extent it was contributed by the fall in the risk premium and enlarged investing of foreign investors into the securities. Unlike Q1, when NBS intervened by selling foreign currencies, during Q2 it intervened by foreign currencies purchases of 170 million euros (mostly in the first half of April). Depreciation pressures caused by the escalation of geopolitical tensions concerning Ukraine crisis emerged at the beginning of Q3. Furthermore, the resignation of the Minister of Finance has led to an occurrence of unfavorable news about the scope and pace of fiscal consolidation in the following period. The risks relating to implementation of fiscal consolidation are reflected in insufficient scope of measures that are implemented and in a lack of confidence in their implementation, in the conditions of constantly growing macroeconomic risks. Since July, the nonresidents in the foreign exchange market again emerged in the role of net customers. Thus, the NBS in July and August intervened on MDT mainly by selling foreign currency (since the beginning of the year until the beginning of September NBS bought 200 million euros and sold more than 900 million euros). Most of the currencies of the countries in the region with the similar exchange rate regime strengthened in Q2, while since of July depreciation pressures start to occur (Graph T5-7). Although the dinar exchange rate movement was mostly in the line with the average trend of this group of countries, dinar depreciated during the period when the currencies in other countries substantially appreciated (January and May 2014), while dinar depreciation in the periods of depreciation of regional currencies was stronger. It can be concluded that the movement of the dinar exchange rate was in part the result of global factors, but a slightly higher depreciation than average was affected by the political situation and uncertainty regarding fiscal reforms in the country (election of the Government of Serbia at the beginning of the year, the change of the Minister of Finance and the risks related to the implementation of fiscal consolidation).

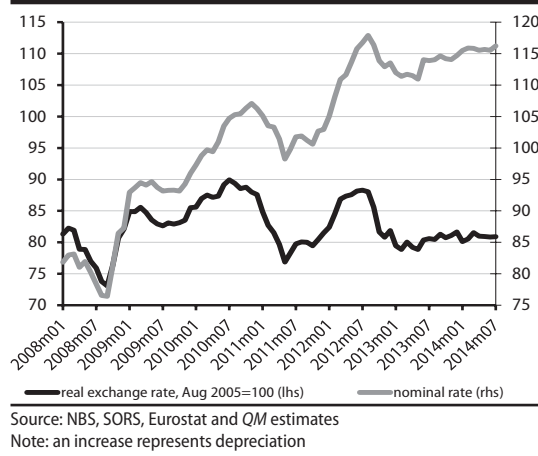
Moderate real appreciation in Q2 and depreciation in the period July-September

After a real appreciation in Q1 of about 0.1%, the dinar appreciated in real terms during Q2 by additional 0.8% (mostly in April), only to depreciate in real terms by a relatively modest 0.05%. Overall real appreciation since the beginning of 2014 until the end of July was 0.9%. NBS interventions in the second quarter prevented a considerable appreciation of the dinar. We estimate that in a highly euroized economy such as Serbian it is desirable for the central bank to prevent large exchange rate fluctuations. In the euroized economy exchange rate fluctuations transfer to a large extent onto inflation and intermittently create large capital gains and losses, thus reinforcing macroeconomic stability.

The real exchange rate has mainly followed the movement of the nominal exchange rate

The movement of the real exchange rate in Q2 was mostly influenced by the ratio of domestic inflation and inflation in the eurozone countries, which in some months led to divergent trends in nominal value and the real exchange rate (Graph T5-8). At the beginning of Q3, the main cause of the movement of the real exchange rate is the nominal value of the exchange rate, and then the value of inflation in Serbia and the Eurozone. Nominal depreciation in August was signifi-

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



early September), any significant improvement of competitiveness would occur with the acceptable costs on the side of inflation (which is extremely low) and the costs of loan servicing.

cantly higher than the July, so it can be expected that the real depreciation will be higher (which will be known when the data on inflation become available). The real exchange rate in the past two years has been relatively stable, but in the future, with an expected slight increase in inflation in Q3 and Q4 and a similar trend of the exchange rate as in July and August, it can be expected the trend to change towards a mild real depreciation. Real depreciation in July and August practically annulled the appreciation from the beginning of the year. Moderate depreciation affects the improvement of the economy competitiveness, and if the depreciation continues in September as well (which is likely to happen, given that the exchange rate reached the value of around 119 dinars per euro in the