5. Prices and the Exchange Rate

In 2014 inflation has moved around the lower limit of the NBS target band and at the end of April amounted to 2%, which is below the range of the corridor of 2.5% to 5.5%. Low domestic demand and a stable exchange rate of the dinar are still the most important factors that influence the maintenance of inflation at an extremely low level in comparison to normal values in Serbia. Relatively high January inflation was of temporary character, given that it was caused by one-off changes in the special VAT rate and excise duties, as well as the seasonal increase in the food prices, and then, this price leap in January was mitigated by low inflation and deflation over the next few months. In the following months it is not expected for inflation to exit the limits of the target band (especially not above the upper limit), taking into account the steady movement of the dinar exchange rate, the expected real decline in wages, pensions and expenditures on goods and services (and the consequent reduction in domestic demand) and a slowdown in economic activity. The movement of the nominal dinar exchange rate, and in particular depreciation pressures at the beginning of the year were, in 2014, partly a consequence of global factors and partly a consequence of economic imbalances and risks, as well as the suspense concerning the parliamentary elections. Bearing in mind the NBS commitment to sustain the foreign exchange rate at a relatively stable level by intervening in the interbank market, as well as the expected inflation movement within the target band, in could be expected that the movement of the nominal and real dinar exchange rate will be stable.

Prices

During Q1 and in April, inflation was around the lower limit of the NBS target band

Slowdown in inflation and its movement within the limits of the target band, which was achieved in late 2013, was continued in the first quarter of 2014. Since inflation reached the target level in September, it has stabilized and its value has moved around the lower limit of the target band, with occasional drops below the target range (table T5-1, Graph T5-2). Such a movement marks the longest period since 2010 during which the inflation moved within (or below) the target limit. However, as the band limits were then at significantly higher values than today, this certainly represents the longest time period with a stable low inflation. Low inflation was contributed by the stable dinar exchange rate, low domestic demand, low imported inflation and further implementation of the restrictive monetary policy, with a very slow mitigation of restrictiveness (even though inflation in April amounted to 2%, the key policy rate was reduced in the

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
okt	177.6	2.2	2.6	0.2	2.3
nov	176.5	1.6	2.0	-0.6	-1.8
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

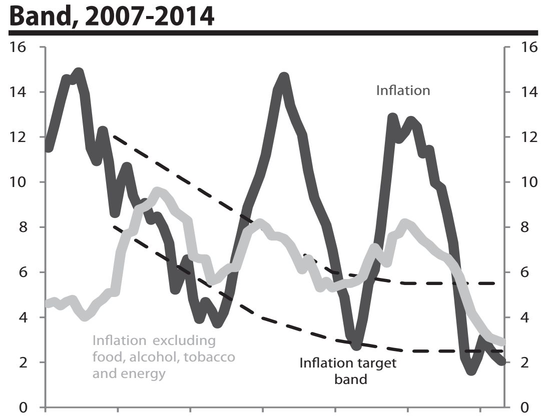
* Three-month moving average of a price growth rose to an annual level. (For example, the March value is obtained by raising the average monthly price growth in January, February and March to an annual level).
Source: SORS.

observed period to still relatively high 9%). Underlying inflation (inflation excluding food, alcohol, tobacco and energy products) is also located within the permissible values and in April, it amounted to 2.9%, which is its lowest level in recent years (Graph T5-2). In the following months inflation is expected to moderately grow and further move within the corridor limits. The inflation growth, in addition to food prices (since last year's base of these prices is at a low level), will be affected by the exit from the account of the last-year's period with relatively high values of monthly inflation, which lasted until June 2013 and the entrance into the period (July--December) when the inflation was on average negative and amounted to around -0.1% on a monthly basis. On the other hand, the expected real drop in the wages and pensions, implementation of fiscal consolidation measures and a slowdown in economic activity will have a disinflationary effect, which will prevent any major price growth.

The gradual relaxation of the monetary policy restrictiveness by the NBS

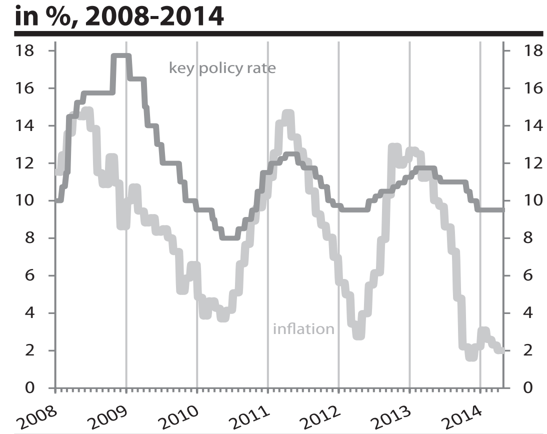
Since the inflation returned within the limits of the target band in September, there was a modest reduction in the key policy rate from a relatively high level of 11%, so at the end of the April it amounted to 9.5% (Graph T5-3), while in early May, it reduced to 9%. Caution of the NBS in keeping the inflation within the limits of the corridor can be explained by the fall of liquidity in the global market (reduction in the volume of quantitative easing by the FED), geopolitical events and Serbia's exposure to movements on the international capital market. In the first quarter of 2014, the key policy rate was kept at the December level of 9.5%, while in May, it decreased to 9%. The current account deficit was significantly reduced and the reduction continued in Q1 (below 4% of GDP), both because of a growth in exports due to the recovery in external demand of major foreign-trade partners, and because of the drop in imports in terms of a drop in domestic demand. The existence of the persistent and growing fiscal deficit and rapid growth of Serbia's public debt, as well as a high level of non-performing loans in the economy continue to create unfavorable conditions for conducting a proper monetary policy of maintaining low inflation, thus more restrictive monetary policy than the one which would be more suitable to the circumstances of such low an inflation must be implemented. Again, it is worth noting that, in order to maintain the macroeconomic stability, a more significant reduction in the restrictiveness of monetary policy by reducing the key policy rate is possible only after solving the problem of structural imbalances- high fiscal and foreign-trade deficit. Until then, we recommend that the NBS, despite present risks, should continue with the cautious reduction of the restrictiveness of monetary policy.

Graph T5-2. Serbia: Y-o-y Inflation Rate and Underlying Inflation and the NBS Target Band, 2007-2014



Source: NBS and *QM* estimates

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



Source: NBS

Low inflation in Q1 and April 2014

After a relatively high inflation in January of about 1.5%, that was, next to seasonal increase in the food price, caused by one-off effects of an increase in a special VAT rate and excise duties, there was a period of a low inflation in February (0.11%) and April (0.56%) and deflation in March of 2014 (-0.33%). Thus, at the end of Q1 inflation stood at relatively low 1.2%, while in April it was 0.6% (Table T5-4). In addition to previously analyzed contributions to inflation in

January (increase in the prices of food, computer equipment, books and other products to which special VAT rate is applied, utilities, as well as petroleum products and tobacco due to an increase in excise duties) in the period January-April a most prominent inflation was in the growth of the prices of fruit (14%, i.e. 0.4pp) and vegetables, whose January growth mitigated March price reduction (overall growth of 13%, or 0.67 percentage points) and the April price increase of postal services (31%, i.e. 0.1pp). Prices of clothes and footwear, after expected seasonal growth at the end of the last year, have continually decreased since the beginning of the year (a total decline of -3.4% and -0.1 percentage points), while a fall in the prices of telephone equipment had a deflationary effect (-9 % and -0.05 pp).

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

	Share in CPI (in %)	price increase in Q1 2014	Contribution to overall CPI increase (in p.p.)	Price increase in April 2014	Contribution to overall CPI increase (in p.p.)
Total	100.0	1.2	1.2	0.6	0.56
Food and non-alcoholic beverages	34.5	1.8	0.6	1.4	0.47
Food	30.9	2.0	0.6	1.4	0.43
Alcoholic beverages and tobacco	7.8	6.5	0.5	-0.1	0.00
Tobacco	4.2	9.6	0.4	0.0	0.00
Clothing and footwear	4.6	-3.2	-0.1	-0.1	-0.01
Housing, water, electricity and other fuels	13.0	0.9	0.1	0.0	0.00
Electricity	5.1	0.0	0.0	0.0	0.00
Furniture, household equipment, routine maintenance	4.1	-0.3	0.0	0.3	0.01
Health	6.4	1.5	0.1	0.8	0.05
Transport	12.3	1.0	0.1	-0.2	-0.02
Oil products	5.1	1.6	0.1	0.0	0.00
Communications	5.0	-1.6	-0.1	1.3	0.06
Other items	12.2		0.0		0.00

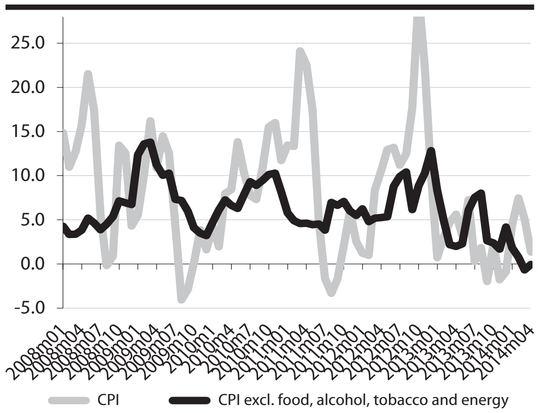
Source: SORS and *QM* estimates

Overall, as well as underlying inflation are at a low level

Underlying inflation (inflation excluding food, alcohol, tobacco and energy) since the beginning of the year has been held at a steady low level it reached in the late 2013. In April, its three--month average and annualized value amounted to approximately 0% (Graph T5-5). Given that almost the entire inflation growth since the beginning of the year was precisely contributed by the growth in the price of a group of products that are excluded from the underlying inflation, overall inflation was little higher but still relatively low in April (3m average of 1.4%, or 5.5% when annualized). Zero underlying inflation is achieved due to a stable dinar exchange rate and low inflationary expectations of the citizens, economy and the financial sector. The news about decrease in Serbia's credit risk by the Fitch rating agency did not cause the growth of the country risk premium (measured by the EMBI index), since it was compensated by the announcements about the possibility to conclude the arrangement with the IMF and the implementation of fiscal consolidation program following the formation of a new Government of the Republic of Serbia. As a result, the underlying inflation trend hasn't changed and it remained at a low level. After the expected seasonal growth in the prices of fruit and vegetables since the beginning of the year, a seasonal decline in their prices and further disinflationary pressure can be expected in the coming months. The existence of inflationary pressures by the demand isn't expected, since the overall domestic demand will continue to decline due to a planned real fall in government spending (wages, pensions and expenses for goods and services), which would further lead to a decline in demand for goods and services. Extremely high (and still growing) unemployment rate suggests that not even the movement of earnings in private sector will have an inflationary impact, while a one-off effect of the increase in special VAT rates and excise duties, which was relatively modest, is now exhausted. Thus, only the effect of changing the base (exit from the account of last-year's months with relatively high inflation and remain in the account of the months with low and negative inflation) can have the only "inflationary impact" in the future period.

It is not expected that the floods will cause the increase in the prices of agricultural products and overall inflation

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



Source: SORS and *QM* estimates

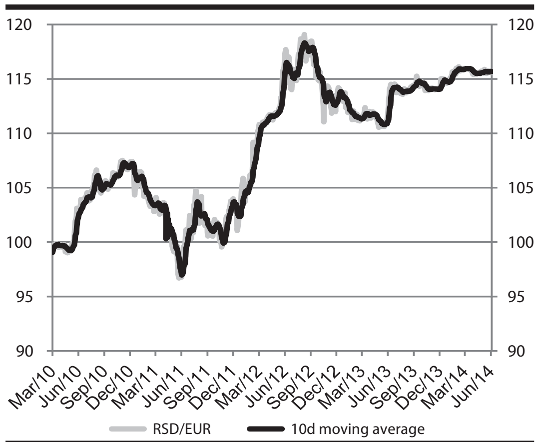
Catastrophic floods that hit Serbia during the second half of May have caused relatively high damage to agricultural production. However, floods have affected a small part of arable land (see Highlight 2), so they will not significantly affect the overall agricultural production in Serbia. In addition, we estimate that the floods will have more influence on the decline in exports than on the growth in the prices of agricultural products. It is possible that the floods will cause the jump in the vegetable prices, but that increase will be limited due to a competitive pressure of imported products.

The Exchange Rate

Relatively stable dinar exchange rate in Q1, April and May of 2014

After a moderate January depreciation, the dinar exchange rate has been relatively stable since the beginning of the year, with minimal fluctuations in the range of 115 to 116 dinars per euro. Such a movement is a continuation of a last year's steady exchange rate movement from September to late 2013 (Graph T5-6), followed by a mild depreciation in January (by about 1.5%) and stabilization with the reacting of NBS (the sale of foreign exchange reserves by mid-March and the purchase from late March to late May of 2014). Since the beginning of the year National Bank of Serbia has continued with the interventions to prevent the excessive daily fluctuations, as well as a mitigation and stopping of a dinar depreciation trend. It, therefore, counting from the beginning of the period of mitigation of depreciation pressures until mid-March 2014, had a sale of total 820 million Euros, and then, by alleviating relatively weak appreciation pressures, it intervened in the interbank market by buying 150 million Euros until the end of May. In this way, it prevented the cancellation of desirable effects of a mild dinar depreciation and additional weakening of the competitiveness of the Serbian economy.

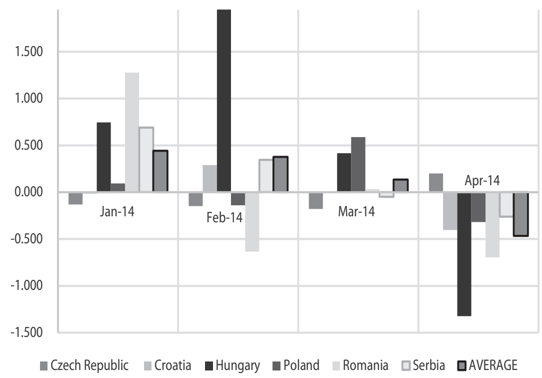
Graph T5-6. Serbia: Daily RSD/EUR Exchange Rate, 2010-2014



Source: NBS

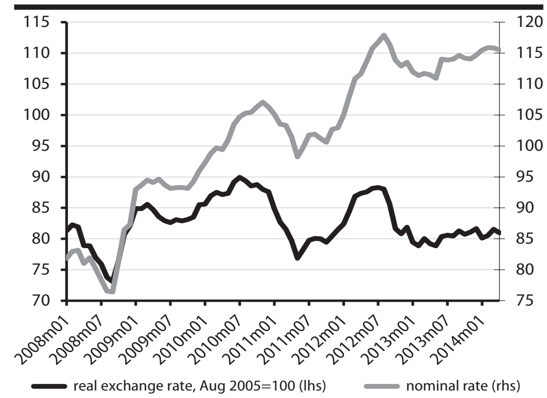
The global factors had the greatest impact on the exchange rate movement since the beginning of the year. The similarity of the exchange rate movement between Serbia and countries of Eastern and Central Europe with a flexible exchange rate regime is especially visible in January and April (see Graph T5-7). Global depreciation pressures in January are largely a consequence of starting a gradual reduction in the volume of quantitative easing by the FED (10 billion dollars per month), which reflected the movement of the exchange rate not only in Serbia, which is due to a large fiscal and moderate external imbalance exposed to impact of the international financial market, but also in most countries with emerging markets. The implementation of FED's decision had only the effect of temporary shock and in the following months the exchange rates stabilized. In April, most countries reported a mild appreciation of the domestic currency, as a result of reduction in the risk premiums in most countries of the region.

Graph T5-7. Nominal Exchange Rate Depreciation in Period of January-April 2014 in Chosen Central and Eastern European Countries



Source: Eurostat, NBS and *QM* estimates

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



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

Real exchange rate relatively stable in 2014

Over Q1 the real exchange rate against the euro remained nearly unchanged, mostly as a result of low inflation in Serbia and almost fixed dinar exchanged rate against the euro. The movement of the real dinar exchange rate was mostly influenced by the variations in domestic inflation, which in some months led to a divergent movement of the value of a nominal and real exchange rate, although the changes were not great. Historically looking, the real exchange rate over a longer period (since the late 2012) has had approximately the same index values (Graph T5-8). Bearing in mind the expected future stable movement of the nominal exchange rate (as well as due to a readiness of NBS to maintain the exchange rate at approximately constant level) and relatively low inflation values, one might expect the stable movement of the real exchange rate without large fluctuations in the future.