NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report – February 2017

Dr Ana Ivković, General Manager
Directorate for Economic Research and Statistics

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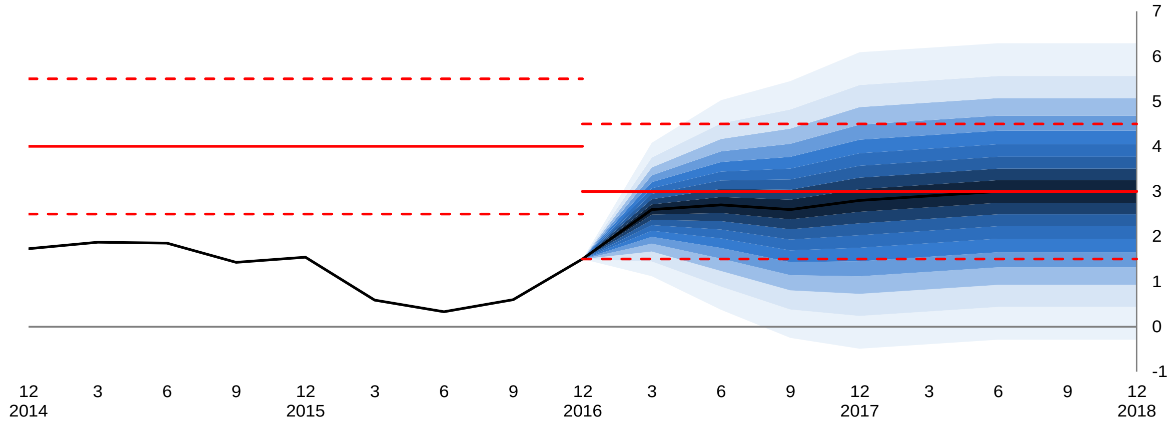
Ladies and gentlemen, esteemed members of the press, fellow economists,

Welcome to the presentation of the February *Inflation Report.* As usual, we will present key information from the *Report*, most notably information about current economic trends, new macroeconomic projections and monetary policy decisions.

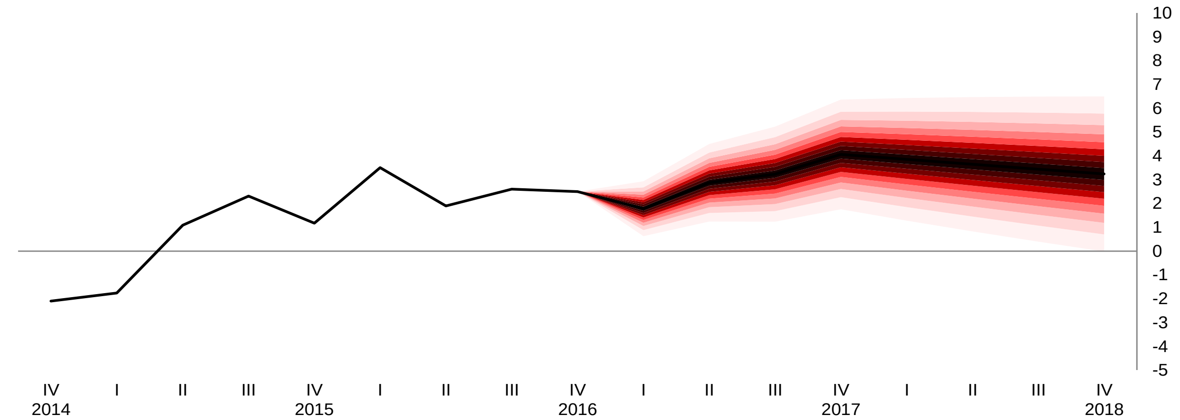
Last year was marked by subdued inflationary pressures, rising economic activity and continued narrowing of internal and external imbalances. We expect these trends to continue in 2017. Consistent with the November projection, our new projection envisages that inflation should enter the new, lower target tolerance band early this year (3.0% ± 1.5 percentage points). It should then remain relatively stable within the target band until the end of the projection horizon. We estimate that economic growth will accelerate further to around 3% this year and around 3.5% in 2018, led by investment and exports but also increasingly by household consumption.

Chart 1 **Inflation projection**
(y-o-y rates, in %)



Additionally, consistent with our expectations stated in the November *Report*, internal and external imbalances continued to narrow. The three-year objectives under the fiscal consolidation programme were achieved in 2016, a year earlier than planned. The consolidated budget deficit fell to 1.4% of GDP. This is much lower than the quantitative criterion of 2.1% of GDP set for the sixth review of the arrangement with the International Monetary Fund. As a result of the fiscal efforts made so far, the share of public debt in GDP was reduced and we expect this trend to continue in the coming years.

Chart 2 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

With exports of goods and services growing much faster than imports in 2016, the trade deficit was 21% lower than a year earlier. As a result, the current account deficit narrowed further – from 4.7% to 4% of GDP. Foreign direct investments in Serbia exceeded their 2015 level, measuring close to EUR 1.9 bln or 5.4% of GDP. For the second year in a row, FDIs were more than sufficient to cover the current account deficit. The results achieved in terms of narrowing of external imbalances were one of the important factors contributing to the relative stability in the foreign exchange market.

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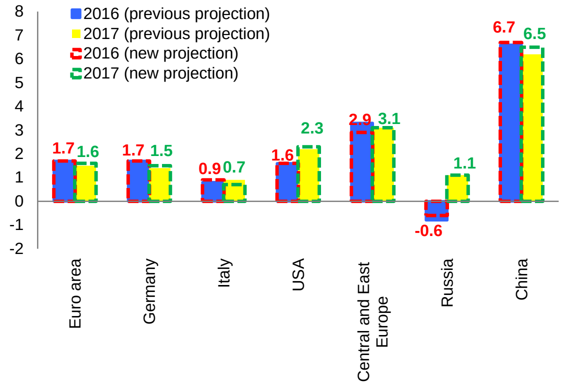
Esteemed members of the press, fellow economists,

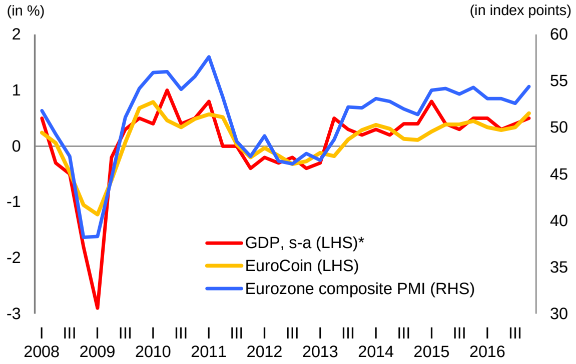
Since we last met, developments in the international environment were marked by improved global economic growth prospects and recovering global oil prices, while monetary policies of leading central banks diverged further. Euro area growth prospects improved, which should have a positive impact on other countries of the region that are also Serbia's important foreign trade partners.

Chart 3 **Revisions of real GDP growth forecasts for 2016 and 2017 by the IMF**
(in %)



Sources: IMF WEO (October 2016) and IMF WEO Update (January 2017).

Chart 4 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)

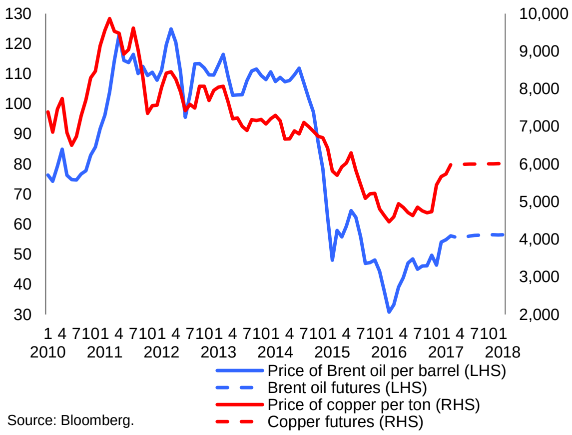


* Eurostat preliminary estimate for Q4.

Global oil prices rallied over the past months, but remain volatile. They were lowest in mid-November (around USD 44 per barrel), but rose to around USD 55 per barrel in late 2016 after the largest oil producers reached agreement on production caps. Oil price movements in the period ahead will depend primarily on whether this agreement is actually put in practice. Oil futures point to marginal oil price growth this year; based on them, oil prices will measure around USD 56 per barrel in December 2017 and maintain a similar level in 2018 as well.

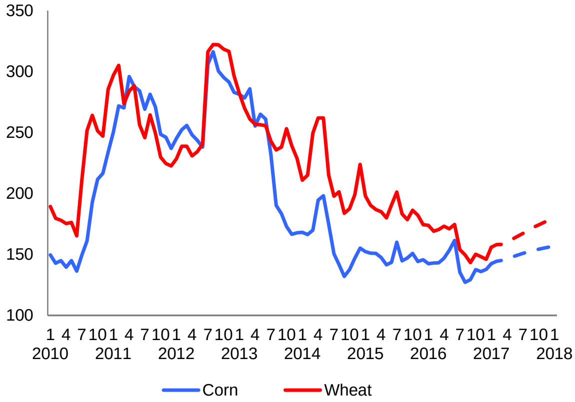
Next to oil prices, the prices of other primary commodities also regained ground. The announced infrastructure projects and other measures to boost the US economy and the stimulus measures in China drove up the prices of iron, copper, aluminium and other metals. Also significant for Serbia are grains prices which rose in the global market late last year, but were still lower than in 2015. According to grains futures, however, gradual growth in these prices is likely to continue in the period ahead.

Chart 5 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

Chart 6 **Prices of primary agricultural commodities and their futures**
(USD/t)



Source: CBOT - Chicago Board of Trade.

As monetary policies of leading central banks diverged further, the uncertainty regarding their impact on global capital flows increased. The Fed raised its policy rate in mid-December, for the second time in one year, signalling increased likelihood of faster-than-expected monetary policy normalisation. The ECB, on the other hand, kept its policy rate on hold, but decided in December to extend the duration of its quantitative easing programme until end-2017, while reducing its monthly purchase volume from EUR 80 bln to EUR 60 bln from April onwards.

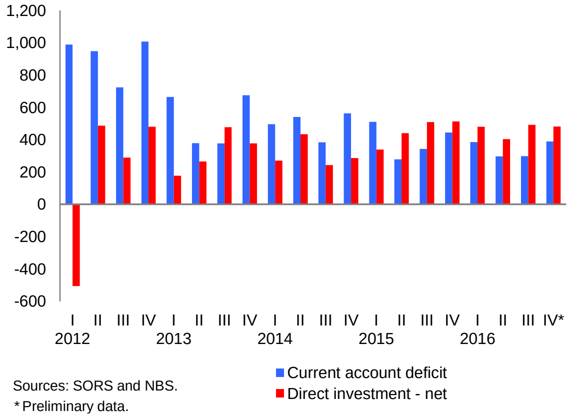
International developments reflected on reduced portfolio investment in emerging economies, including in Serbia. Still, thanks to a sustained narrowing of external and internal imbalances, the exchange rate of the dinar was relatively stable. A contribution to exchange rate stability was also provided by the NBS through both foreign exchange purchase and sale interventions in order to prevent excessive short-term volatility of the exchange rate.

Increased likelihood that the pace of the Fed's monetary policy normalisation would be faster than initially expected led to a rise in the risk premia of emerging economies in Q4. Since late 2016, however, the risk premia of these economies have been falling. Serbia's risk premium declined to 194 basis points in mid-January, which is its lowest level since October 2007. This decline was also due to domestic factors, including most notably a further narrowing of internal and external imbalances and acceleration of economic growth. Serbia's risk premium currently stands at 214 basis points.

That Serbia's macroeconomic performances and outlook are positive was also confirmed by the IMF's decision in December on successful completion of the sixth review of the stand-by arrangement. In addition, Standard & Poor's raised Serbia's credit rating outlook in December based on the results of fiscal consolidation and implementation of structural reforms, acceleration of investment-based economic growth and narrowing of external imbalances resulting from a strong rise in exports.

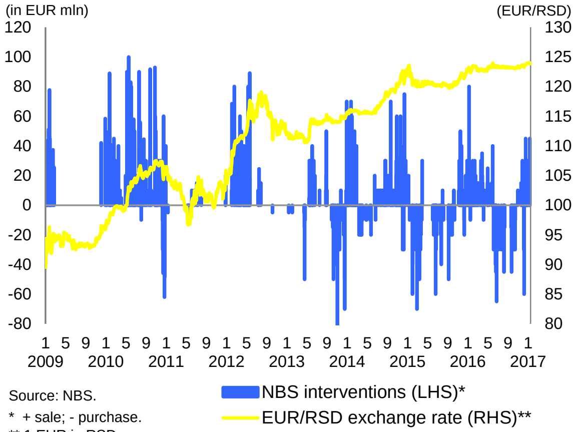
The key contribution to a substantial narrowing of fiscal imbalances came from austerity measures on the expenditure side of the budget, but the contribution of income also increased in 2016 as a result of improved tax collection and faster economic growth. The consolidated budget deficit measured 1.4% of GDP, while, interest expenses excluded, a surplus of 1.8% of GDP was recorded.

Chart 7 **Current account deficit and net capital inflow**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

Chart 8 **Movements in EUR/RSD exchange rate and NBS FX interventions**



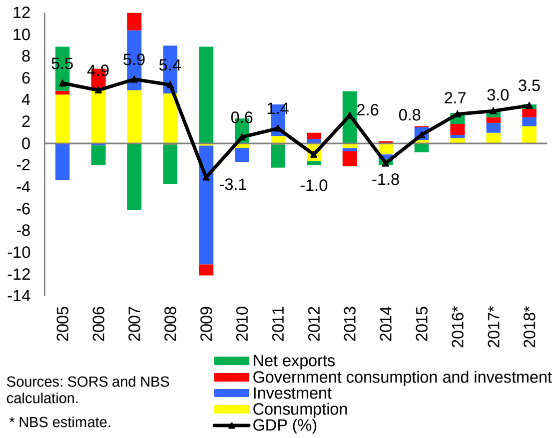
Source: NBS.
* + sale; - purchase.
** 1 EUR in RSD.

* * *

As regards economic activity, according to the preliminary estimate of the Serbian Statistical Office, gross domestic product grew by 2.5% y-o-y in Q4 2016, while its growth in 2016 as a whole is estimated at 2.7%. For an extended period of time, a positive impact on industrial activity on the supply side came from earlier investments, the still relatively low oil prices and lower costs of borrowing, while, on the demand side, industrial activity was supported by a gradual rise in domestic and external demand. Besides industry, a positive contribution also came from agriculture, thanks to an exceptional season, as well as from construction and the majority of service sectors. Based on our estimate, GDP growth was driven by investment and exports on the expenditure side. Household consumption also provided a positive contribution, mostly thanks to an improved labour market situation.

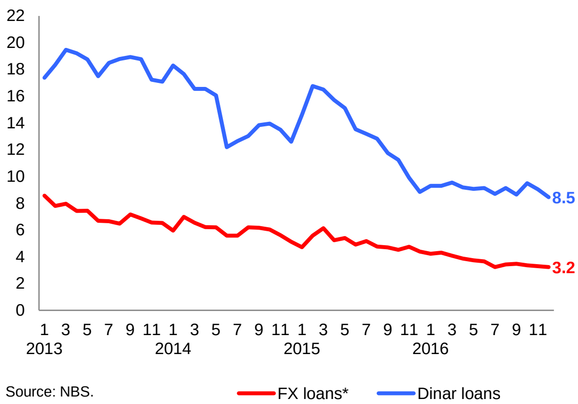
According to our estimate, economic activity will accelerate further to around 3% this and around 3.5% next year. On the expenditure side, this year's growth will continue to be led by investment and exports based on continued implementation of infrastructure projects and an improved investment ambience. A positive contribution is also expected from final consumption, mostly due to the anticipated rise in employment and private sector wages. GDP growth in 2018 will be supported by domestic demand, i.e. investment and consumption, and the contribution of net exports will remain positive thanks to relatively high export growth rates.

Chart 9 **Contributions to y-o-y GDP growth**
(in pp)



Sources: SORS and NBS calculation.
* NBS estimate.

Chart 10 **Interest rates on new loans to private sector**
(weighted average values, p.a., in %)



Source: NBS.
* Euro and euro-indexed.

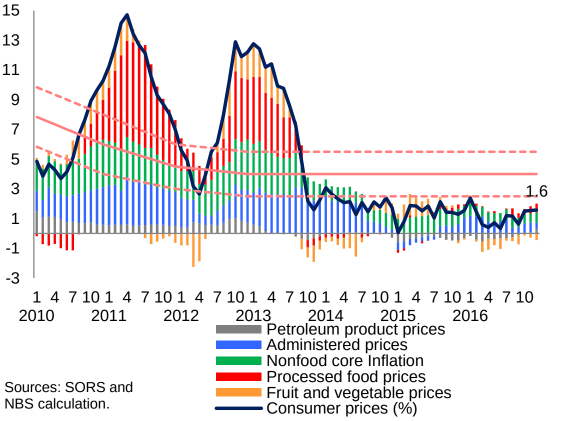
Past monetary easing, further narrowing of internal and external imbalances and increased interbank competition continued to reflect positively on the cost of borrowing for the private sector. Average rates on dinar loans to corporates and households each decreased in Q4 by 0.5 percentage points, to 5.4% and

10.8%, respectively. Lower costs of borrowing for the private sector were also supported by low interest rates abroad and increased interbank competition – average interest rates on euro-indexed loans to corporates and households each decreased by 0.3 percentage points, to 3.1% and 4.4%, respectively. Along with the acceleration of economic activity, favourable interest rates contributed to a rise in lending activity which measured 1.9% y-o-y in December.

* * *

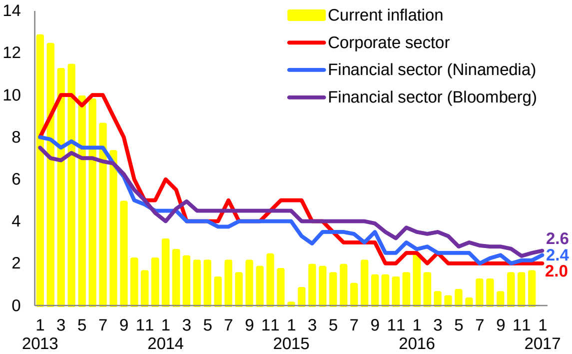
Inflationary pressures remain subdued. Year-on-year inflation increased in Q4 to 1.6% in December, as a result of the low base effect, and higher electricity and petroleum product prices. Looking at domestic factors, the key contributors to weak inflationary pressures were the effects of fiscal consolidation, relative stability of the exchange rate, low inflation expectations, and successful agricultural season. While global oil prices regained some ground, encouraging a modest inflation rise in the euro area, the impact of prices from the international environment stayed relatively weak.

Chart 11 **Contribution of CPI components to y-o-y inflation**
(in pp)



Sources: SORS and NBS calculation.

Chart 12 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.

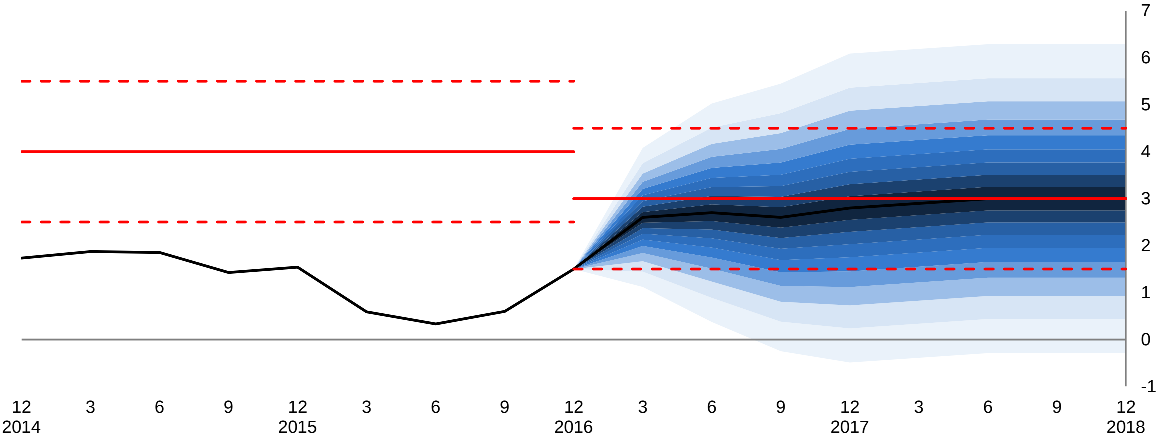
* Ninamedia agency since December 2014, and Ipsos and Gallup in the prior period. The survey was not conducted in November 2014.

Quarter-on-quarter, prices grew by 0.5% due to an increase in prices of electricity and petroleum products and the seasonal rise in prices of travel packages, clothes and footwear. Lower prices of unprocessed food worked in the opposite direction.

Under our central projection, y-o-y inflation will enter the target tolerance band in early 2017 (3.0 ± 1.5%), and should remain relatively stable therein until the end of the projection horizon.

Such inflation movements will primarily reflect the low base effect from fruit and vegetable prices, gradual increase in aggregate demand at home and inflation abroad, while low costs of inputs in food production, and the high base for petroleum product prices from March onwards, will continue to hold inflation back for a period of time.

Chart 13 **Inflation projection**
(y-o-y rates, in %)



Source: NBS.

The new inflation projection is slightly higher than the one published in the November *Report*, particularly with regard to the first quarter of 2017. Like in other countries, this is due to the fact that global oil price growth turned out faster than expected. The risks to the projected inflation path are symmetric and mostly associated with future developments in international commodity and financial markets.

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In consideration of the inflation outlook, the new inflation target and the expected effects of past monetary easing, the Executive Board kept the key policy rate unchanged at 4.0% since July.

In making monetary policy decisions in the period since the November *Report*, the Executive Board also took into account the uncertainty in international commodity and financial markets, mostly regarding movements in global oil prices and the pace of the Fed's policy normalisation. In the period ahead, the National Bank of Serbia will continue to closely monitor and assess movements in the domestic and international market and use all available instruments to make sure inflation remains low and stable over the medium term.

Esteemed members of the press, fellow economists,

The February *Report* contains three text boxes that look into topical issues: the first one analyses the impact of seasonal factors on inflation in Serbia, the second deals with the results of NPL resolution efforts so far, and the third tackles the contribution of household consumption to Serbia's economic growth. We recommend these text boxes as they address topics significant to our economy and give answers to questions you frequently ask.

Thank you for your attention. We now open the floor for questions.