National Bank of Serbia

Inflation Report – May 2018

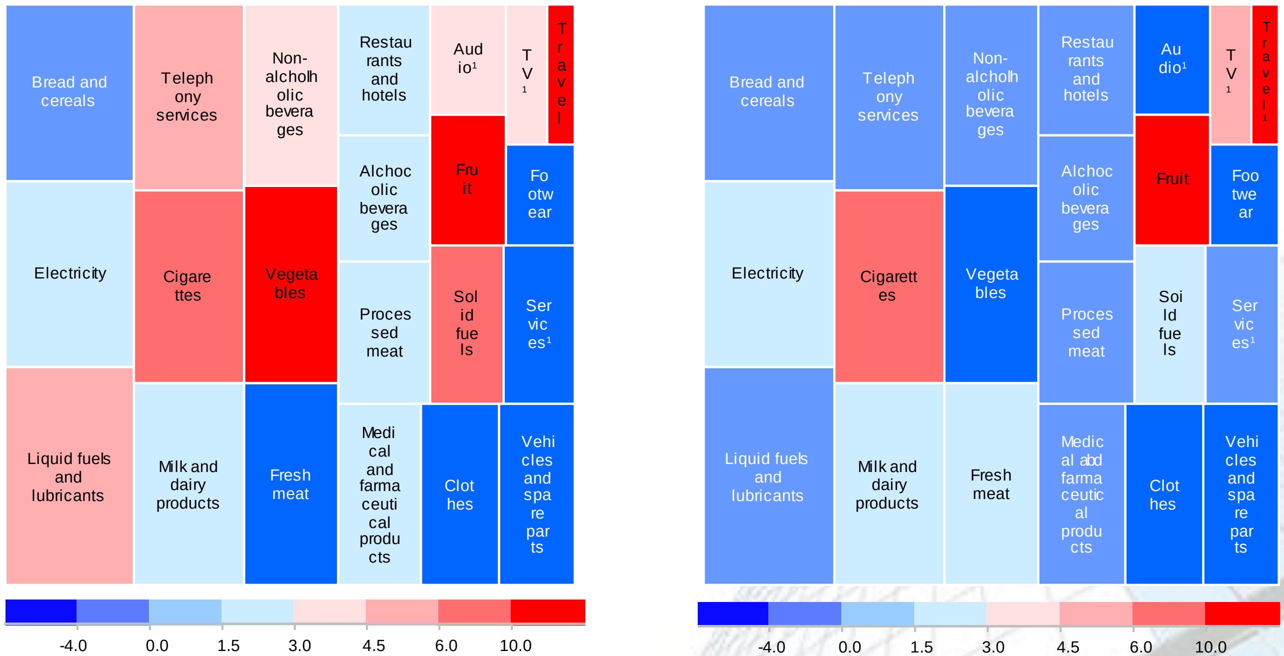
Belgrade, 17 May 2018

National Bank of Serbia

As of early 2018 y-o-y inflation slowed down significantly

Chart 1 **Y-o-y rise in prices of selected products and services** (y-o-y rates, in %)

December 2017 **March 2018**



Sources: SORS, NBS calculation.

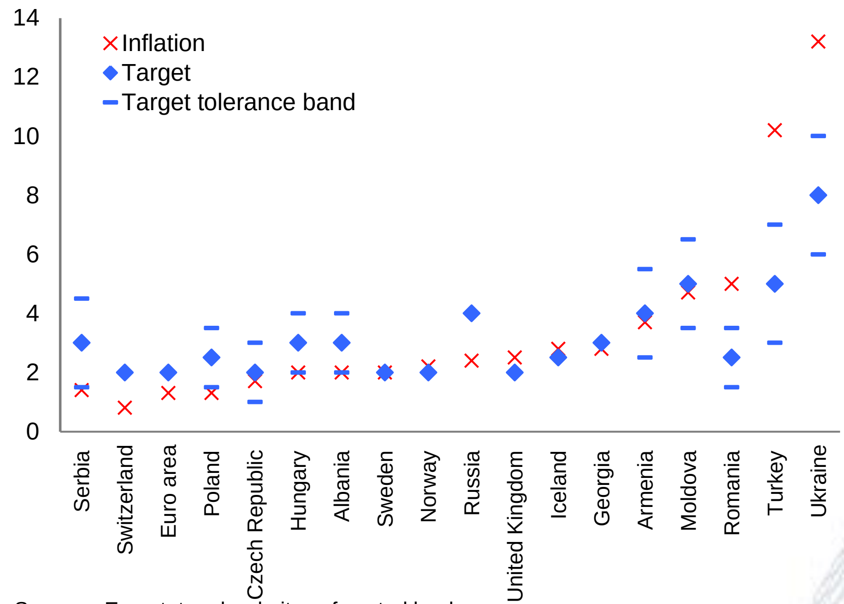
Note: The rectangular area represents a share in consumer basket , while colours stand for the y-o-y price growth range of the category in question.

[1] Audio− audio, TV, computers, telephones and other equipment; TV − TV and CTV subscription; Travel− travel packages; Services − apartment maintenance and repair services.

- In early 2018 inflation in Serbia slowed down significantly, given that now the major portion of consumer basket (around 76%) records y-o-y price growth below the 3.0% target;
- Faster than expected slowdown in inflation largely resulted from the fact that inflation in the international environment Is lower than anticipated, which, coupled with the effects of the past appreciation of the dinar, led to a smaller than expected increase in prices of industrial products, excluding food and energy, in Q1.

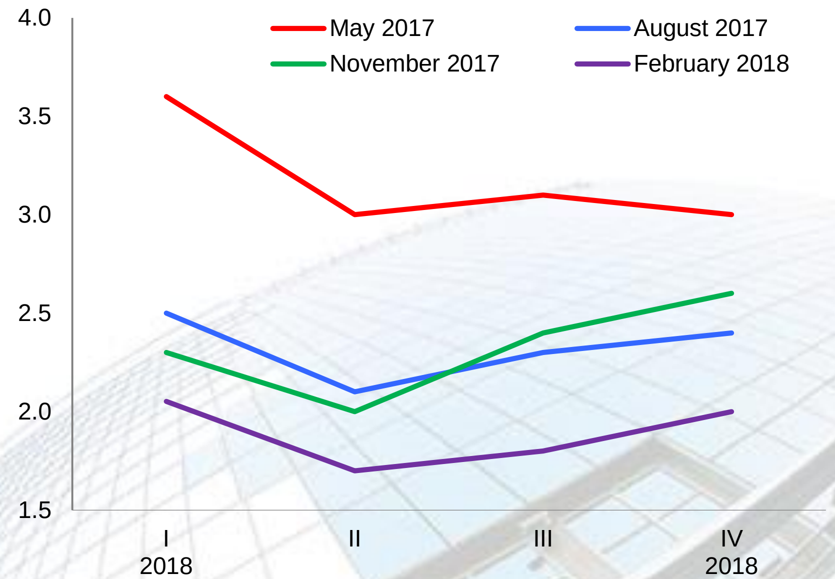
Serbia is in a group of countries with inflation moving around the lower bound of the target

Chart 2 **Inflation and target by country in March 2018**
(in %)



Sources: Eurostat and websites of central banks.

Chart 3 **Central inflation projection for 2018**
(in %)



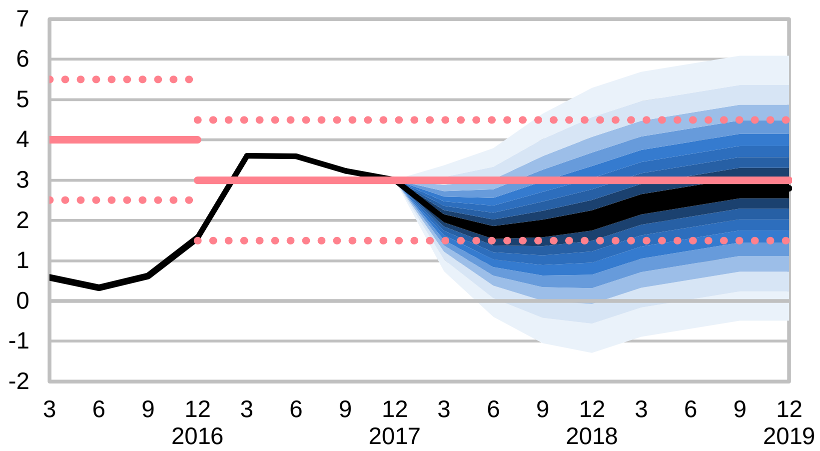
Source: NBS.

- As of the beginning of 2018 Serbia is in a group of countries with inflation moving around the lower bound of the target;
- The NBS decision to continue with monetary policy accommodation was motivated by the expectation of low inflationary pressures in the coming period and the fact that they abated further compared to the February medium-term inflation projection.

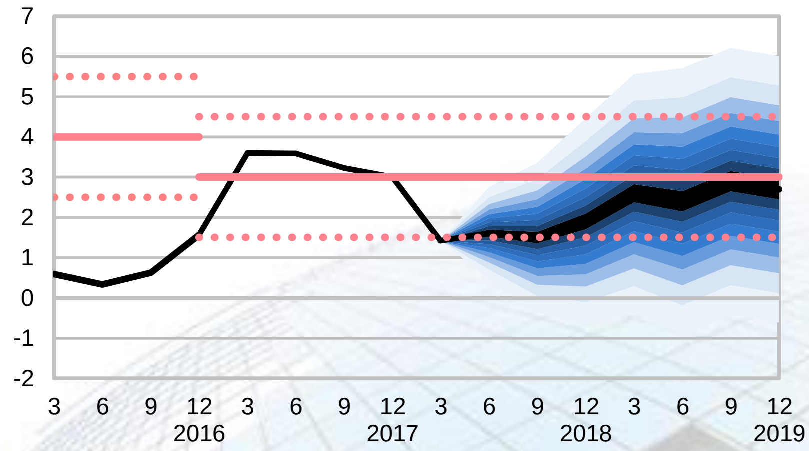
A further drop in inflationary pressures reflected on the new, lower inflation projection

Chart 4 **Current vs. previous inflation projection**

February projection
(y-o-y rates, in %)



May projection
(y-o-y rates, in %)

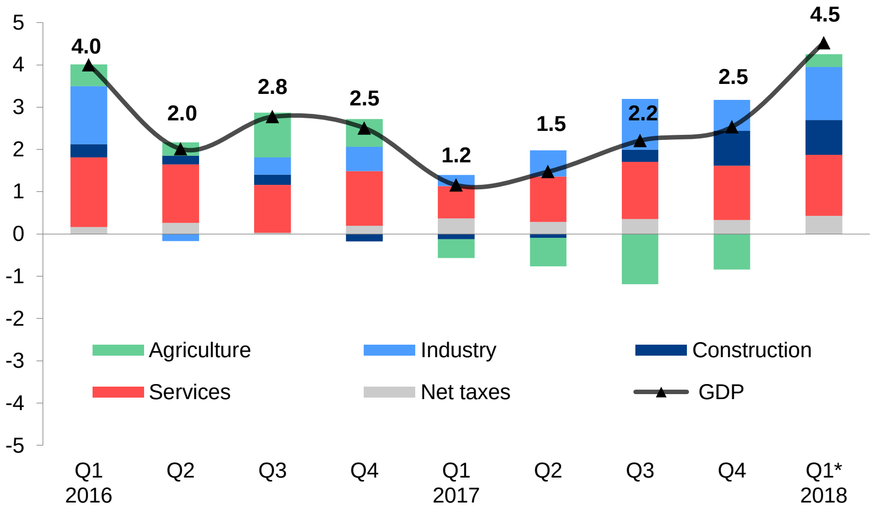


Source: NBS.

- According to May central inflation projection as well, y-o-y inflation will continue to move within the target band of 3.0±1.5% until the end of the projection horizon;
- The new medium-term inflation projection is lower than the one published in the February *Inflation Report*, until the end of the projection horizon, due to the smaller than expected consumer price growth in Q1 2018, reflecting the appreciation of the dinar in the past period, low inflation in the international environment and persistently low costs of food production;
- Risks to the inflation projection are symmetrical and are primarily associated with future movements in global commodity and financial markets and, to a degree, administered price growth and the performance of this year's agricultural season.

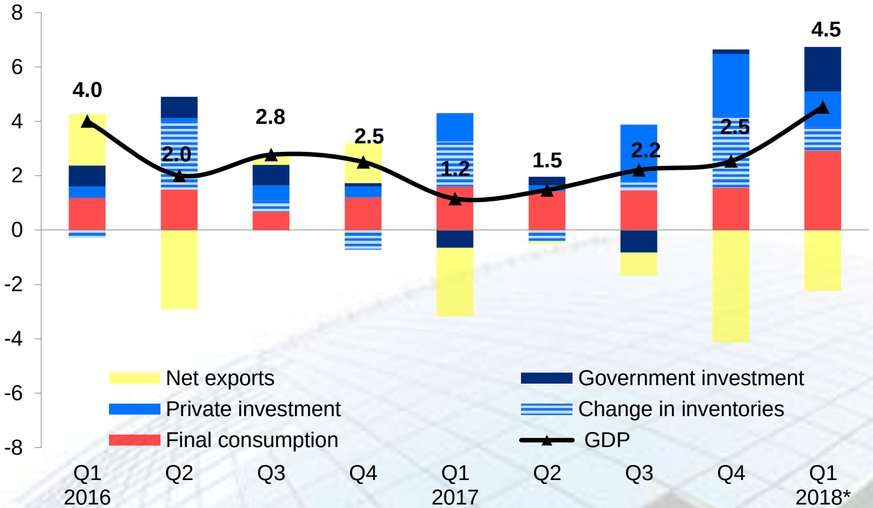
In Q1 GDP sped up to 4.5% y-o-y owing to robust investment growth

Chart 5 **Production side - contribution to real GDP growth,** (in p.p.)



*NBS estimation

Chart 6 **Expenditure side - contribution to real GDP growth,** (in p.p.)



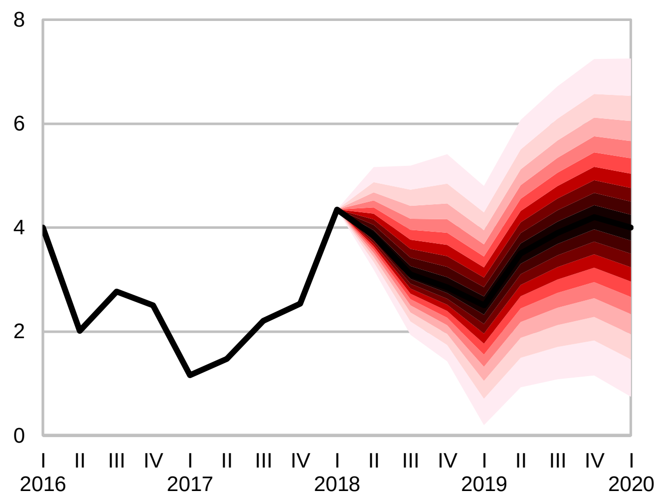
*NBS estimation

- According to the preliminary Statistical Office data, in Q1 real GDP grew at 4.5% y-o-y.
- Faster than expected growth was spurred by strong expansion of construction activity, of around 25% y-o-y (+0.8 pp).
- A strong impetus to GDP growth also came from a continued rise in manufacturing and increasingly more favourable movements in service sectors.
- The low base effect from Q1 2017 equalled 0.3 pp in agriculture and around 0.5 pp in energy.

- According to our estimate, in Q1 fixed investment gained 16.5% y-o-y in real terms, adding 2.9 pp to GDP growth – 1.1 pp more than initially expected.
- Apart from high growth of government investment, this is also confirmed by high growth of equipment imports, FDI, new investment loans and higher profitability of corporates in 2017.
- Faster growth of final consumption reflects faster growth of employment and wages in the private sector.
- The greatest contribution to imports growth came from imports of raw materials and equipment, and the smallest from imports of consumer goods.

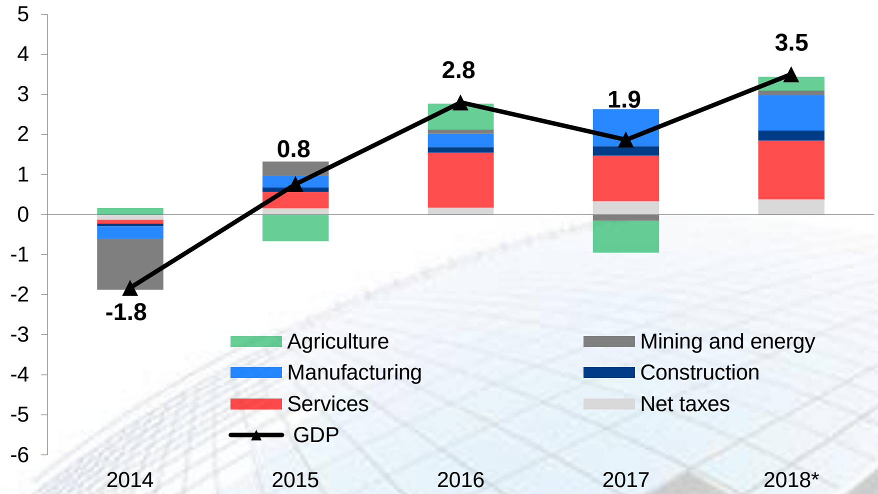
Projected GDP growth for this year is 3.5%, with risks skewed to the upside

Chart 7 **GDP growth projection,**
(y-o-y rates, in %)



Source: NBS.

Chart 8 **Production side - contribution to annual GDP growth,** (in p.p.)



*NBS judgement

- The risks to the projection for 2018 are assessed to be skewed to the upside, primarily in construction and investment.
- The risks also pertain to euro area growth and movements in international commodity and financial markets.
- On the expenditure side, fixed investment will record real growth of minimum 8%, exports will continue up at a two-digit rate, while consumption will speed up in real terms to over 3%.
- Due to necessary import purchases of equipment and raw materials, imports will grow faster than exports.

Observed by the key production sectors:

- continuation of favourable trends in manufacturing;

- faster growth of service sectors (trade, tourism, catering, transport, ICT, financial, business and other services);

- construction growing at the last year's rate (5.5%), with pronounced upside risks;

- average agricultural season, effect of +0.3 pp;

- recovery of energy sector, effect of +0.1 pp.

The share of fixed investment will reach 21.5% in 2018, with upside risks

Chart 9 **Real growth and share of fixed investment in GDP**, (in %)

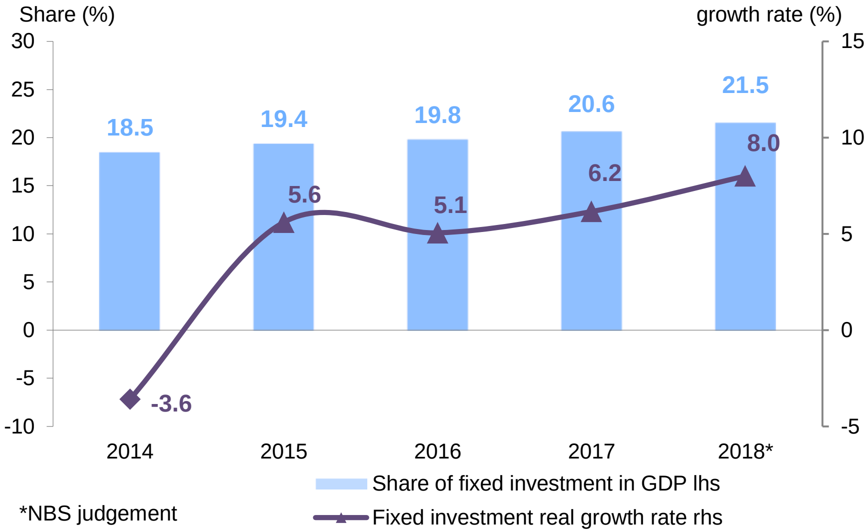
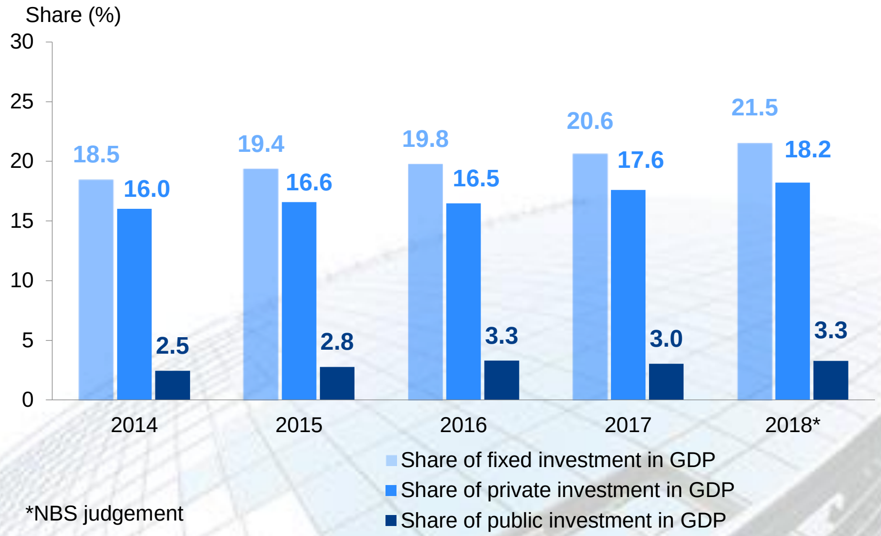


Chart 10 **Share of private and public investment in GDP**, (in %)

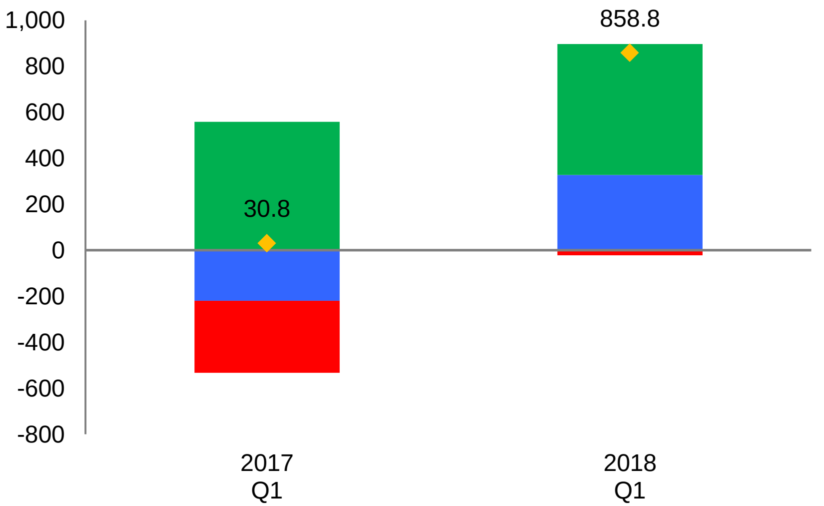


- The growth of fixed investment in the past three years averaged 5.6%, and its share in GDP rose from 18.5% to 20.6%.
- Q1 2018 saw even more favourable trends – fixed investment grew by around 16.5% y-o-y, adding 2.9 pp to GDP growth of 4.5% y-o-y .
- In 2018, under the central projection, fixed investment growth is estimated at around 8%.
- The share of investment should reach around 21.5%.

- In 2017 private investment grew at the strongest rate of 8.7% in the past five years, and will continue to grow at a high rate this year as well.
- A relatively high contribution to GDP growth this year will stem from government investment which more than doubled this year.
- The increasing share of investment crates an excellent basis for sustainable growth in the coming years.
- Should the upside risks in investment materialise, its share in GDP could reach 22% this year.

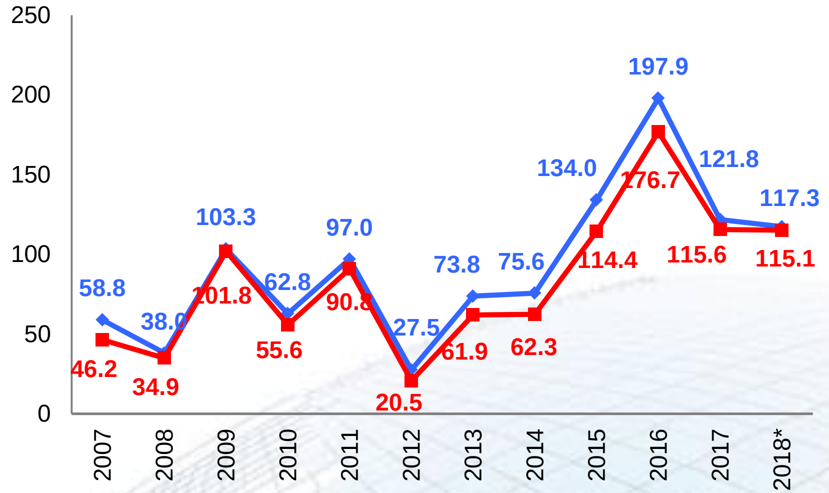
Favourable movements in the financial account

Chart 11 **Movements in financial account**
(in EUR mn)



Sources: SORS and NBS calculation.

Chart 12 **Coverage of the current account deficit by FDI**
(in %)

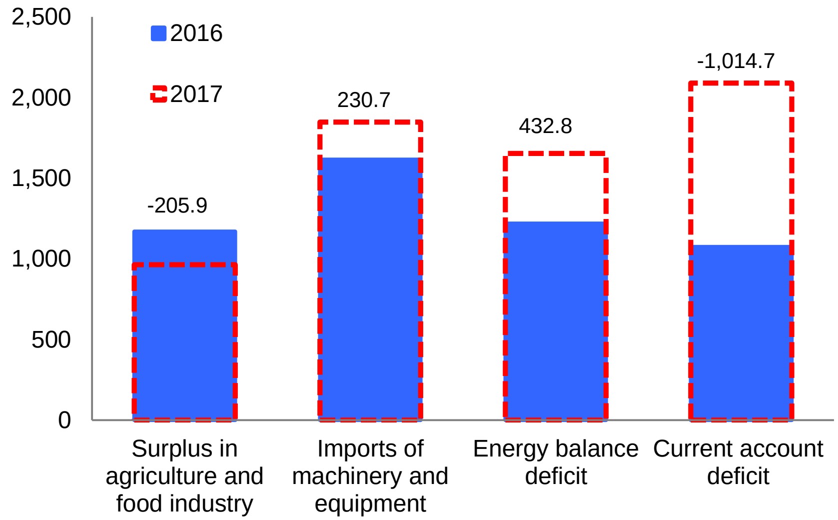


Sources: SORS and NBS calculation.
* NBS projection.

- Movements in the financial account in Q1 2018 are characterised by a high net inflow of direct and portfolio investment of non-residents, while in respect of loans capital flows are almost balanced;
- The new inflow of portfolio investment in Q1 can be attributed mainly to higher non-resident investment in long-term dinar government securities;
- According to our estimate, the net FDI inflow in 2018 will amount to around EUR 2.6 bn and for the fourth consecutive year will be more than sufficient to cover the current account deficit.

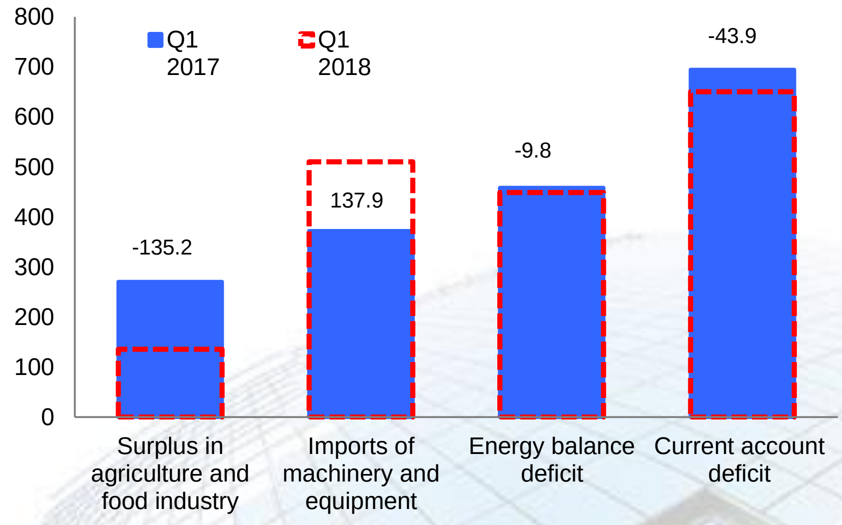
Investment growth drives up the imports of equipment, as well as exports in the medium run

Chart 13 **Most important contributions to change in the current account deficit in 2017**
(in EUR mn)



Sources: SORS and NBS calculation.

Chart 14 **Most important contributions to change in the current account deficit in Q1 2018**
(in EUR mn)

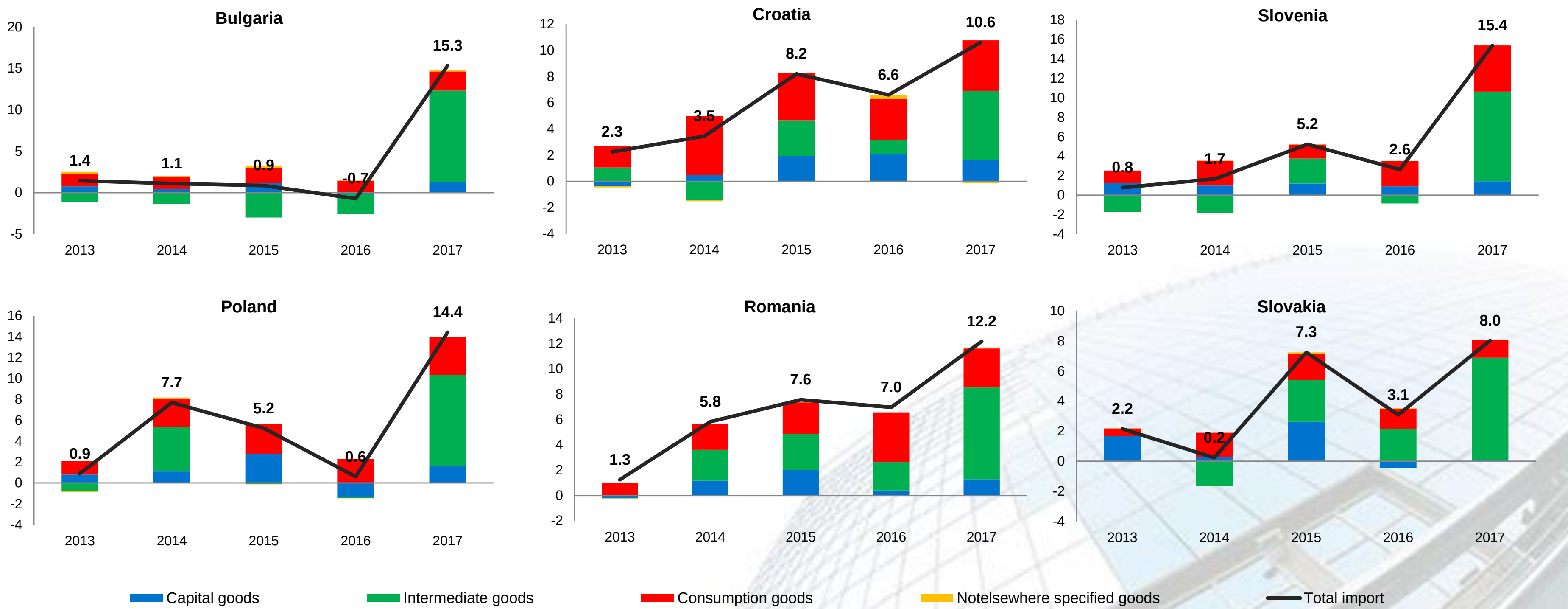


Sources: SORS and NBS calculation.

- Significant acceleration of investment in Q1 reflected also on higher imports of machinery and equipment, pushing up the deficit in goods as well.
- In Q1 2018 import purchases of investment goods sped up, the surplus in agriculture was reduced due to the adverse agricultural season last year, while the energy balance deficit remained at its Q1 2017 level.
- On the other hand, investment should contribute to further growth of production and exports, and by extension, to the narrowing in the trade deficit.

High import growth in countries of the region as well

Chart 15 **Commodity import structure in neighboring countries**
(in p.p.)



- In 2017 countries of the region also recorded significant imports growth (especially intermediate goods);
- As for intermediate goods, around one half of imports growth concerns the rising energy imports.