NATIONAL BANK OF SERBIA

# Speech at the presentation of the Inflation Report – August 2017

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Directorate for Economic Research and Statistics

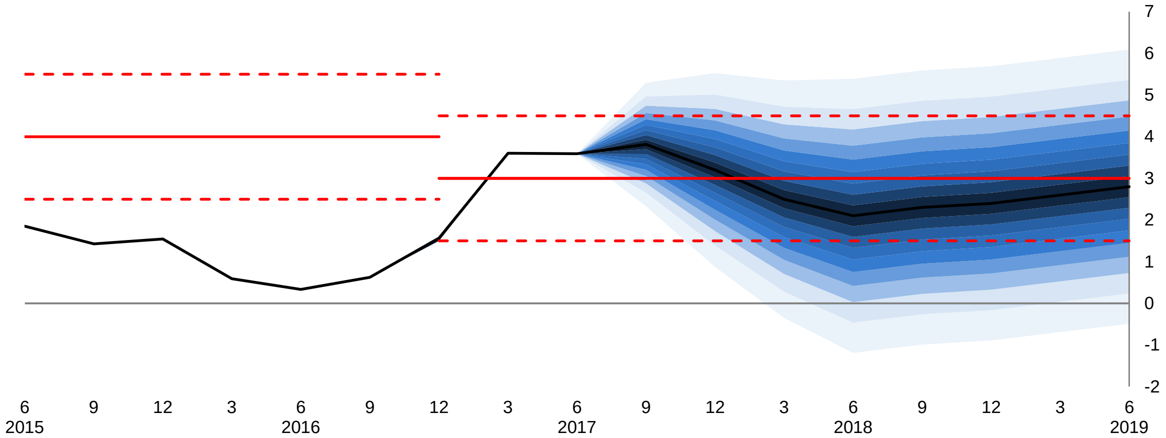
Belgrade, 16 August 2017

*Ladies and gentlemen, esteemed members of the press, dear colleagues*

Welcome to the presentation of the August *Inflation Report*. After the Governor gave an overview of the work of the National Bank of Serbia and the results achieved in favour of citizens and the economy over the past five years, we shall focus on the current economic developments and our new macroeconomic projections.

Since the start of the year, inflation has moved within the new, lower target band of 3.0±1.5%. Its movement over the past several months confirms our estimate from May – in early 2017 it was driven by higher prices of a small number of products and services, with inflationary pressures remaining low. In the second quarter, consumer prices grew at a slower pace than expected in May. Along with falling imported inflation, this is one of the reasons why **we revised downward the new inflation projection compared to the projection that we presented to you in May, both for this and next year**.

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

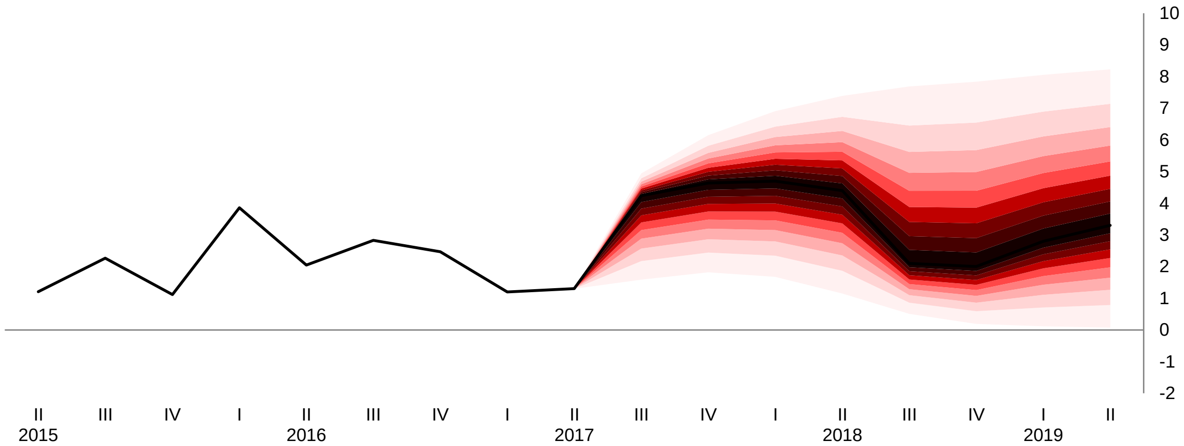



Source: NBS.

At the same time, economic activity is expected to rise in the coming period, aided mainly by acceleration of growth in the euro area and our other important trade partners, continued recovery of domestic demand, the diversified inflow of foreign direct investment, and further improvement in the business and investment environment.

Commodity exports continued to post high year-on-year growth since early 2017, while the rise in imports was largely due to greater needs of industry for equipment and intermediate goods. In the remainder of the year, we expect exports to step up and imports to slow down, which was evident in June as well, which is why we kept our projection of the current account deficit at around 4% of GDP this

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




Source: NBS.

year. The deficit will remain fully covered by the net inflow of foreign direct investment, whose 2017 projection was revised to EUR 1.7 billion as the realisation so far has been higher than expected, exceeding by over 12% the inflow recorded in the same period last year.

Positive fiscal trends continued, with a general government surplus of 2.1% of GDP in the first half of the year, **fuelled mainly by rising fiscal revenue**. Excluding interest expenses, the surplus equalled 5.7% of GDP. Central government public debt, whose upward trajectory was reversed last year owing to fiscal efforts, continued to contract this year.

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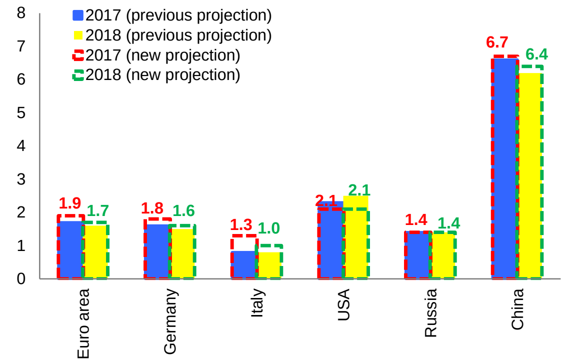
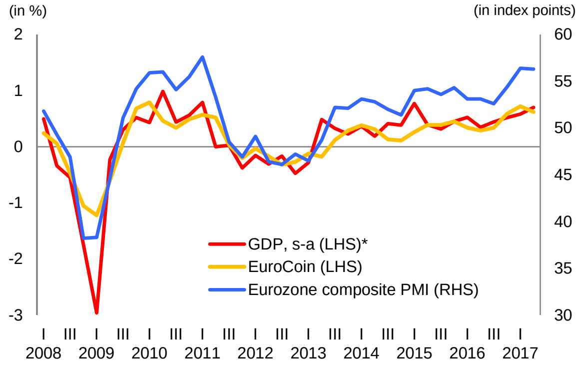
Developments in the international environment over the past months were marked by the improved outlook for global growth, notably in the euro area. The European Central Bank revised upward its projection for euro area growth, expecting its broad distribution, both sector-wise and geographically. Expected faster euro area growth had a positive effect on the outlook in the surrounding countries, which are our important trade partners as well.

Chart 3 **Revisions of real GDP growth forecasts for 2017 and 2018 by the IMF**
(in %)




Sources: IMF WEO (April 2017) and IMF WEO Update (July 2017).

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

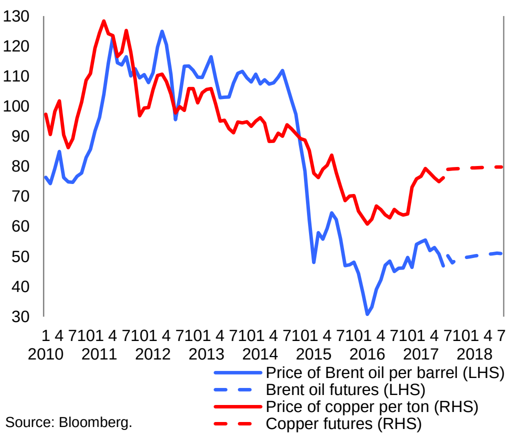



Sources: Eurostat, Markit Group and Banca d'Italia.

* Eurostat preliminary estimate for Q2 2017.

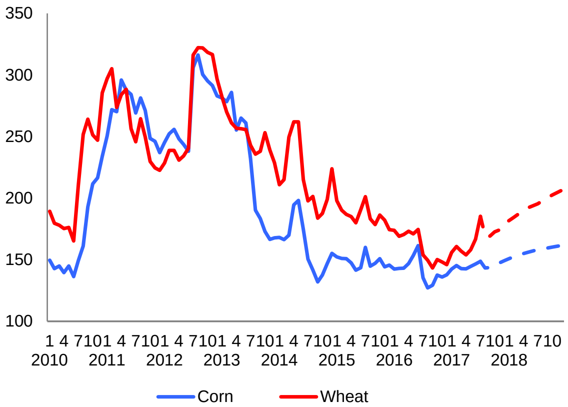
Despite the acceleration of economic growth, inflationary pressures in most countries remain weak, largely on account of the repeated drop in global oil prices. Determined mainly by supply-side factors, in the second quarter global oil prices oscillated between USD 44 and 55 per barrel, underperforming the March figure by 8.5% at end-June. They edged higher in July, but not above USD 52 per barrel. End-July oil futures, which we used in the projection, indicate that oil prices will touch USD 53 per barrel and will not change significantly until the end of 2018. On the other hand, growth in global primary agricultural commodity prices, which began in the first quarter, continued into the second quarter.

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)

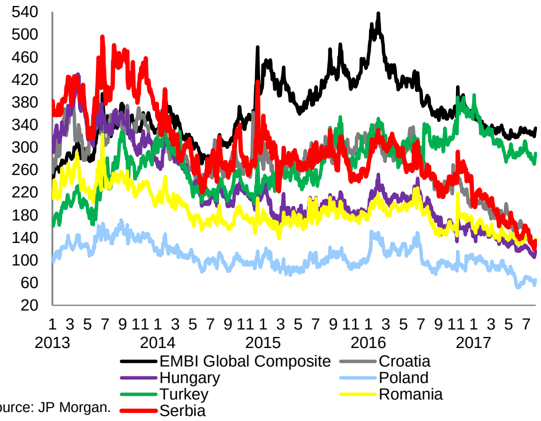



Source: CBOT - Chicago Board of Trade.

As inflationary pressures are subdued, interest rates of most central banks are still at their lowest. In addition, some central banks continue to apply unconventional monetary policy measures, notably the European Central Bank. On the other hand, the Federal Reserve System again raised its federal funds rate in June and announced it would start to normalise its balance sheet until the end of the year, by reducing its reinvestment of repayments of principal on securities purchased in the quantitative easing programme.

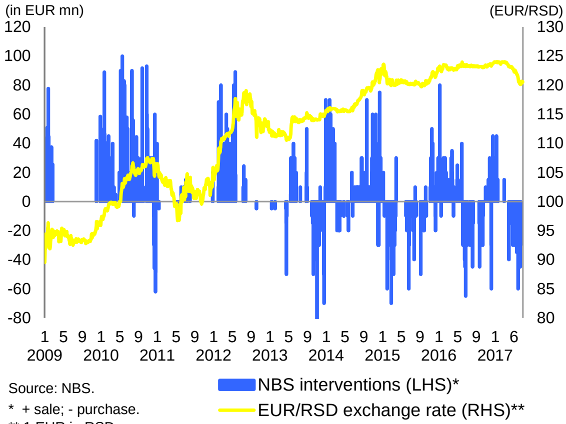
The divergence of monetary policies of leading central banks is creating more uncertainty surrounding global capital flows to emerging economies, Serbia included. However, better outlook for global economic growth raised investor sentiment in the international financial market, which positively reflected on movements in the domestic foreign exchange market, where appreciation pressures prevailed in the second quarter and continued into July. In general, appreciation pressures in the said period were due to better export performance of our economy, a high inflow of foreign direct investment, the return of foreign investors to the government dinar securities market, the seasonal increase in inflows of remittances and growth in FX-indexed bank assets. Relative stability in the foreign exchange market has for quite some time been supported by the improvement in macroeconomic fundamentals, which resulted in the decline in the country risk premium in August to the lowest level on record. To ease excessive short-term strengthening of the dinar against the euro, the National Bank of Serbia intervened in the foreign exchange market by buying EUR 505.0 million in the second quarter, EUR 165.0 million in July and EUR 145 million in August.

Chart 7 **Risk premium indicator – EMBI by country**
(daily, in basis points)




Source: JP Morgan.

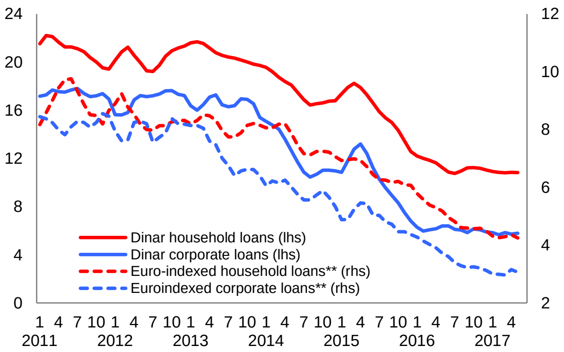
Chart 8 **Movements in EUR/RSD exchange rate and NBS FX interventions**




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

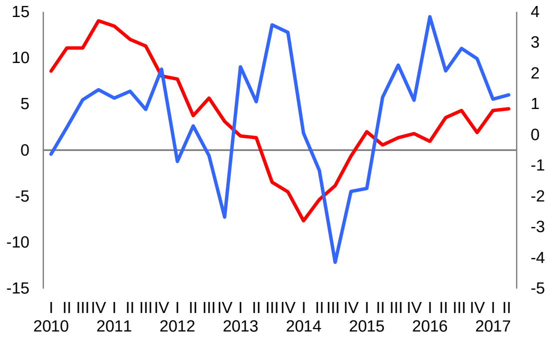
The decline in the country risk premium and interbank competition helped further reduce the private sector's costs of borrowing. The average interest rate on new dinar loans to corporates and households was cut by 0.9 percentage points in the second quarter to 8.5% in June, while the rate on new euro-indexed loans lost 0.2 percentage points, coming at 3.1%. Lower costs of borrowing and the recovery of the economy and the labour market boosted credit activity. In June it accelerated to 4.5% year-on-year and, excluding the effect of NPL write-offs, to 6.7%. Additional qualitative progress in the credit market was made in the segment of housing loans, which in the second quarter posted the highest quarterly growth since 2011, when the subsidised housing lending programme was in place as well. In addition, the share of non-performing loans was at the lowest level since April 2009. In the two years since the adoption of the NPL Resolution Strategy, they dropped by close to 7 percentage points to 15.6% in June.

Chart 9 **Interest rates on new dinar and euro-indexed loans to corporates and households***
(3m moving averages, in %)




Source: NBS.
* Excluding revolving loans, current account overdrafts and credit card debt.

Chart 10 **Lending activity and GDP**
(y-o-y rates, in %)




Sources: NBS and SORS.
* Excluding the exchange rate effect.

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Economic developments since the start of the year were considerably hampered by adverse weather effects that reflected above all on energy and agriculture, while domestic and external demand continued to have a positive effect. According to estimates of the Statistical Office of the Republic of Serbia, GDP growth in the second quarter measured 1.3% year-on-year. In the second quarter, the mining and energy sectors started to recover, and positive trends in manufacturing and service sectors continued.

At year level, GDP growth should be driven by industry and service sectors on the production side. Construction is also expected to contribute positively, while agriculture will be a drag. On the expenditure side, we expect growth to be driven by investment and exports, with a rising contribution of household consumption. GDP growth in 2018 should accelerate owing to the further recovery of household consumption and the continued rise in investment and exports on the back of growing external demand and improvement of the business environment.

A more favourable outlook for euro area growth will act as a fillip to economic activity in Serbia and the surrounding countries, but risks to the projection for this year are asymmetric downward, primarily due to the impact of adverse weather on agriculture and energy. Given that the downward risks to the projection this year are driven by supply-side shocks, whose effects on economic activity will be offset once the conditions normalise, risks are asymmetric upward for the next year on the same grounds.

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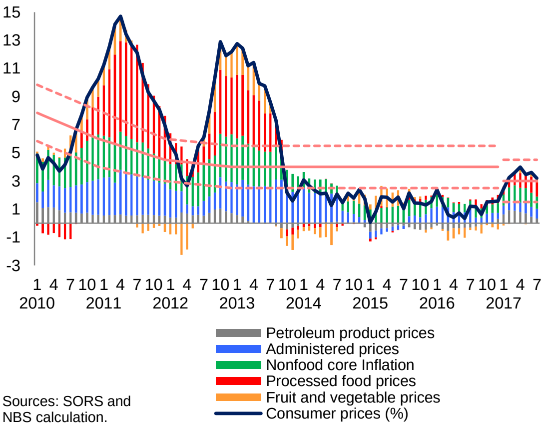
Consumer prices picked up by 0.5% in the second quarter, less than expected in May. Inflation was driven by higher import prices of fruit and fresh meat and the prices of travel packages, while a factor working in the opposite direction was the decline in the prices of vegetables and firewood due to the waning of the effects of cold weather from the start of the year.

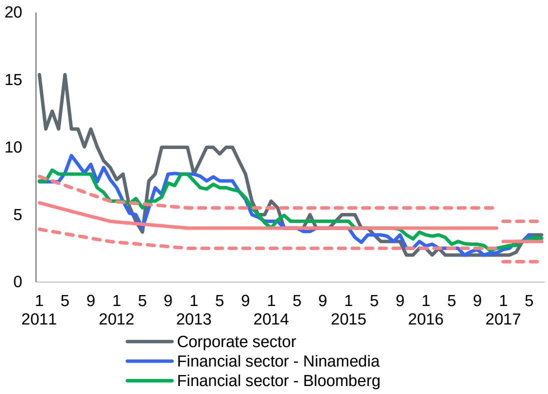
The decline in year-on-year inflation in the past months to 3.2% in July confirmed the estimates from the May *Inflation Report* that the rise in prices at the start of the year was a one-off factor limited to a small number of products and services and that inflationary pressures are still low. This is also confirmed by core inflation, which has been low and stable since the start of the year at around 2%, equalling 1.7% in July, and by inflation expectations of the financial and corporate sectors, which are within the target band of the National Bank of Serbia both for one and two years ahead.

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




Sources: SORS and NBS calculation.

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



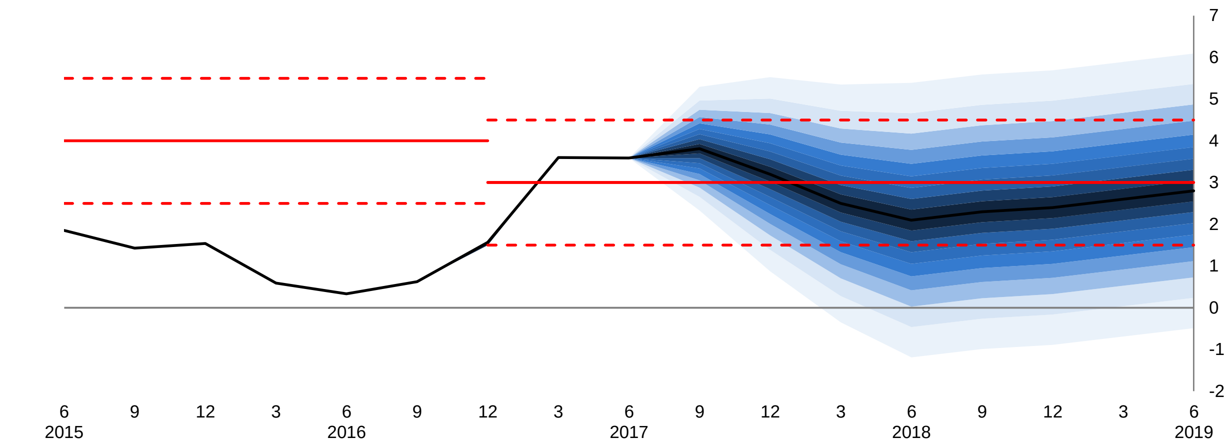

Source: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.

Under the short-term projection, inflation will drop further in August, as a result of the drop-out from year-on-year comparison of last year's meat price increase, after which in September it will rise to a level slightly higher than at the end of the second quarter.

***In the medium run, as also indicated by our new central projection, year-on-year inflation will continue to move within the target tolerance band of 3.0±1.5% until the end of the projection horizon, i.e. in the next two years.***

The high base for petroleum product prices will slow inflation down in the coming period, while in early 2018, once this year's one-off price hikes of some products and services drop out of its calculation, inflation will decline below the current level. A gradual rise in global primary agricultural commodity prices and aggregate demand at home will work in the opposite direction.

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




Source: NBS.

The new inflation projection is lower than stated in the May *Report*, both for this and next year. The projection was revised downward on account of a smaller than expected increase in consumer prices during the second quarter, and lower import prices expressed in dinars, both of primary agricultural commodities and oil.

The uncertainty of the projected inflation path relates primarily to future developments in the international commodity and financial markets and their effect on the prices of petroleum products and food at home, as well as to the impact of agrometeorological conditions on the success of this year's agricultural season. To a degree, the uncertainty also relates to administered price growth this and next year.

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Considering the projected inflation and its factors, as well as the new lower inflation target, the Executive Board has kept the key policy rate unchanged at 4.0% since July last year.

Monetary policy caution in the period observed was also mandated by the uncertainty in the international financial and commodity markets, mainly in terms of the pace of normalisation of the Federal Reserve System's monetary policy and the movement of prices of primary commodities.

In the coming period, the National Bank of Serbia will continue to closely monitor and assess developments in the domestic and international markets and use all available instruments to keep inflation low and stable in the medium term.

*Esteemed members of the press, dear colleagues,*

Please note that the August *Inflation Report* contains two text boxes. In the first, we reflected on the past five years of the work of the National Bank of Serbia headed by Governor Ms Jorgovanka Tabaković, and the accomplished results – measured by achieved and preserved price and financial stability. The second text box presents the Economic Sentiment Indicator, monitored and published by the European Commission, both for EU member countries and Serbia and other EU candidate countries. This indicator is used to assess the current economic developments and the expectations for the coming period.

We thank you for your attention and remain at your disposal for any questions.