Current Macroeconomic Developments

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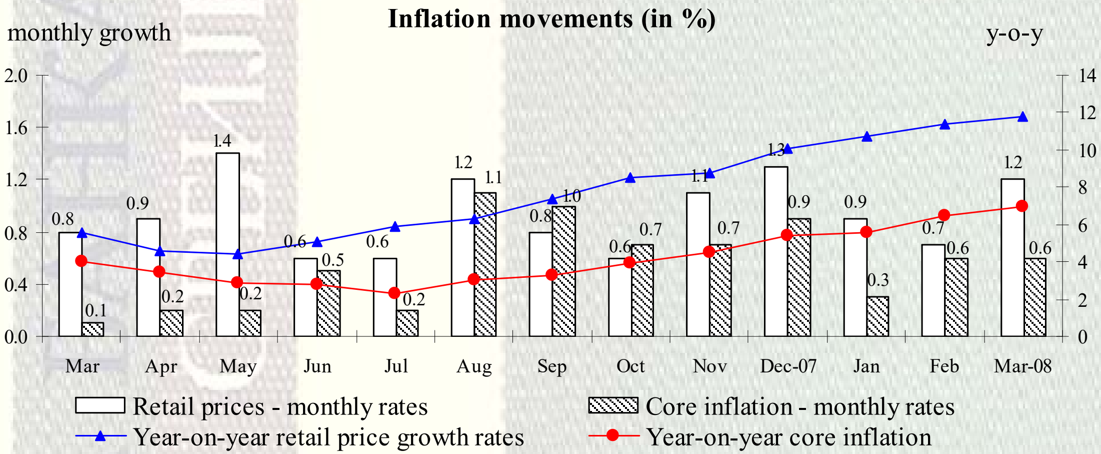
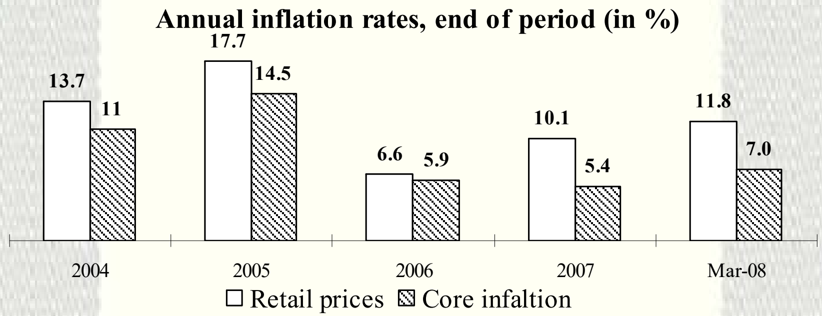
Belgrade, 31 March 2008

Contents

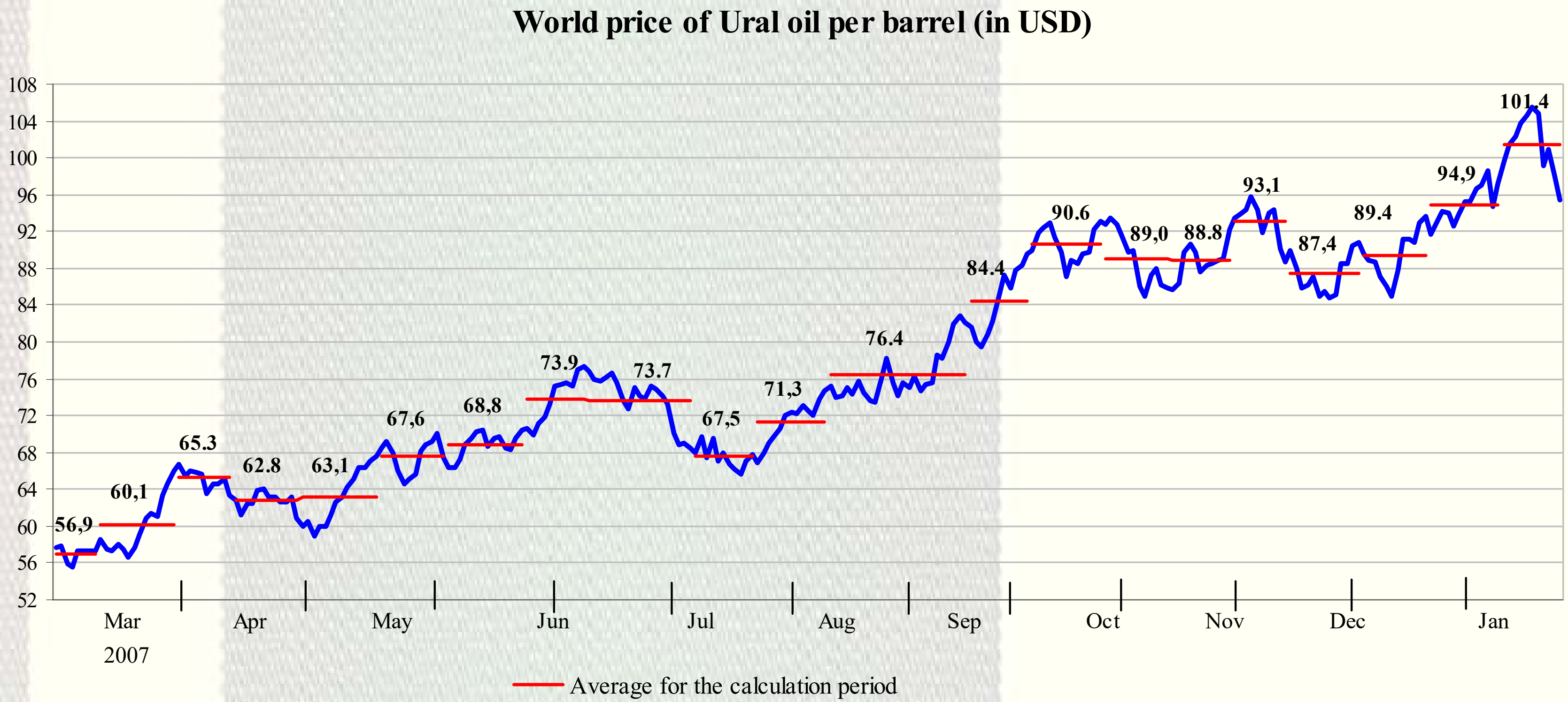
Unfortunately, the rate of inflation is accelerating as expected…





- March 2008:
  - Year-on-year core inflation of 7.0% – above the upper bound of the target corridor set for this year
  - Year-on-year headline retail price growth of 11.8% (of which, 6.8 percentage points is accounted for by growth in regulated prices)
  - Year-on-year, prices of agricultural products rose by 35.5% and prices of oil derivatives by 30.8%

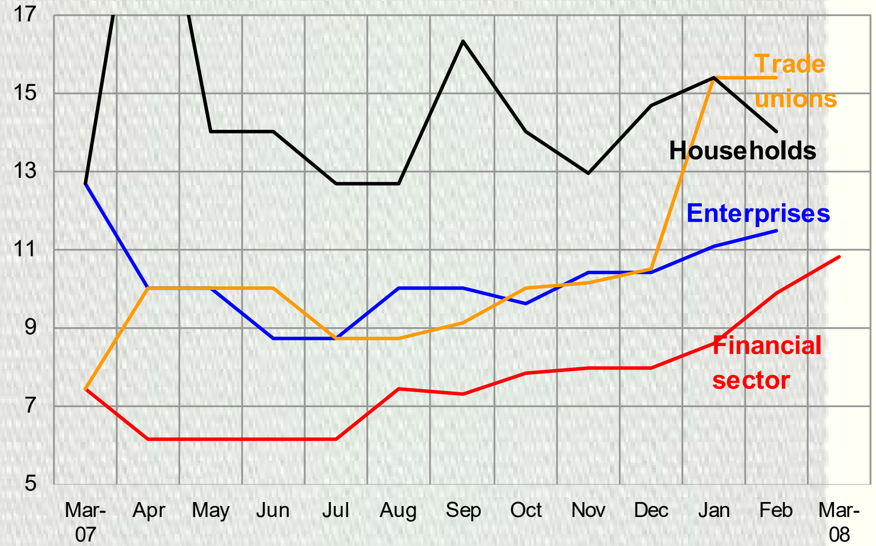
Oil price movements in the world market



- In February, contrary to analysts' expectations, Brent crude prices shot past the psychological barrier of USD 100 per barrel
- In March, world market oil prices continued climbing: on 28 March 2008, Ural oil hit USD 101, while Brent reached USD 104.
- Forecasts of future oil price movements are highly uncertain – a weaker dollar is the only tempering factor!

Growth in inflation expectations picked up in 2008

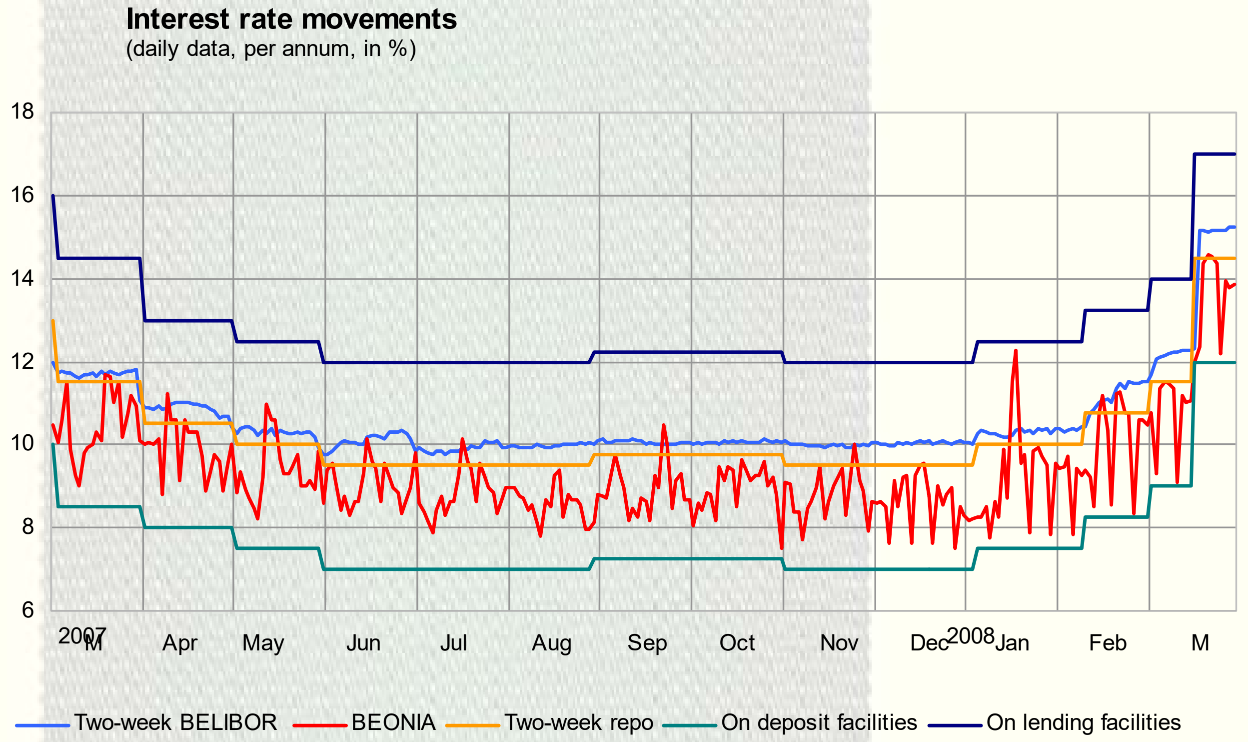
Expected inflation movements over the next 12 months (in %)



Source: Survey (TNS Medium Gallup).

- Relative to February, inflation expectations of the financial sector over the next 12 months rose in March by 1.0% to 10.9%
- Inflation expectations cannot be easily subdued and, like prices, tend to display more downward than upward rigidity

Money market interest rates are influenced by movements in the NBS key policy rate



Source: National Bank of Serbia and Reuters.

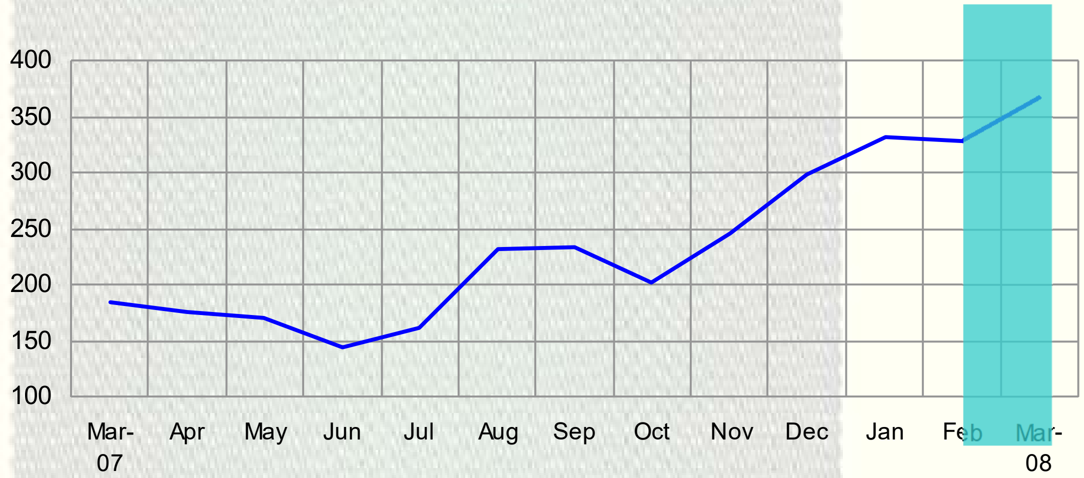
- Money market interest rates mirror changes in the NBS key policy rate
- Bank lending rates are more responsive to changes in the key policy rate than deposit rates – hence, the interest rate margin widened in February
- An increase in the yield curve slope also points to a rise in inflation expectations

Bank lending responds to changes in interest rates

- Though declining mildly in February, bank lending remains relatively high – the highest increase was recorded for cash and housing construction loans
- In January and February, borrowing abroad by the enterprise sector came to USD 861 million or 37.5% up on the same period a year earlier

Heightened risk of investment in transition economies, including Serbia

Risk premium indicator - EMBI for Serbia *
(monthly averages, in basis points)

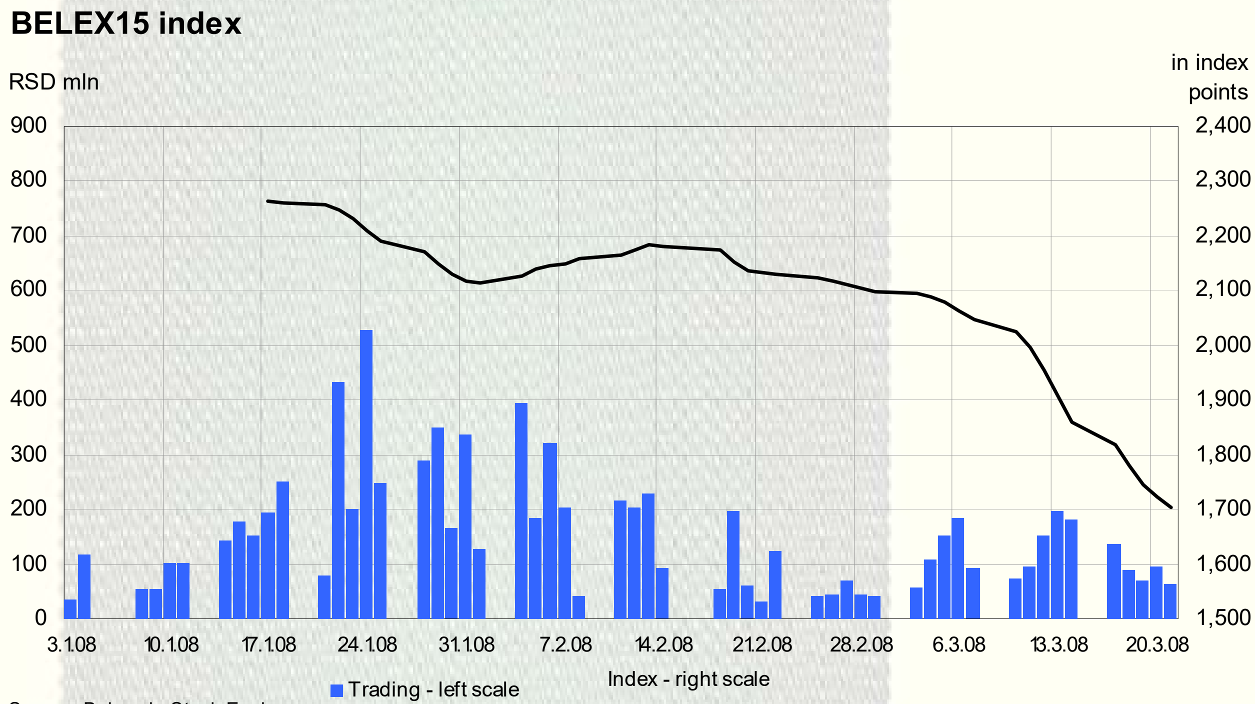


Source: JP Morgan.

*) **EMBI** is a benchmark index measuring the difference between the return on US Treasuries and on Serbian sovereign bonds in the international market.

- Deepening crisis in world financial markets and political instability in the country are the main reasons for foreign investors’ reluctance to invest in Serbia
- In March, Serbia’s credit rating was revised from BB- /stable down to BB- /negative (S&P)

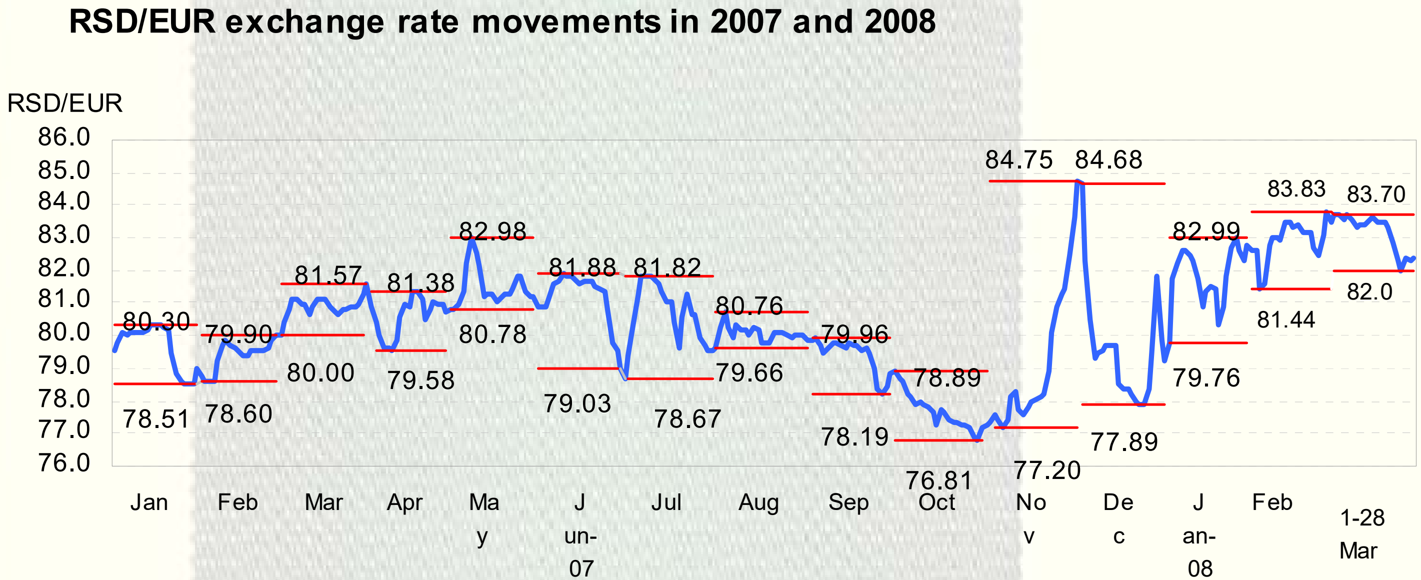
Capital market outlook: further decline in stock exchange indices



Source: Belgrade Stock Exchange.

- In the first half of March 2008, the index of most liquid shares (Belex15) lost about 24% of its value and dropped to its lowest level since December 2006
- Though it rallied somewhat in recent days, the increase is still insufficient to compensate for the drop from the first half of the month

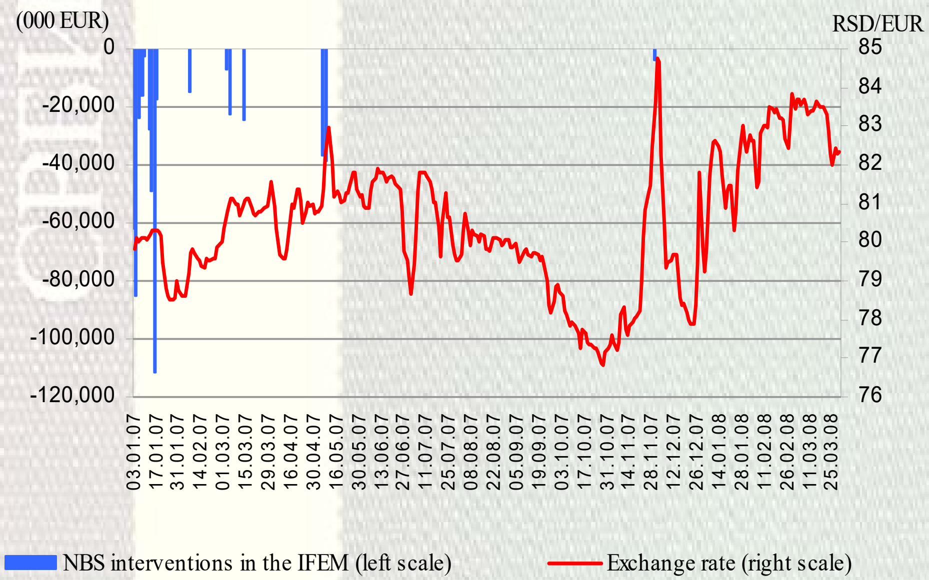
The dinar appreciated slightly around mid-March



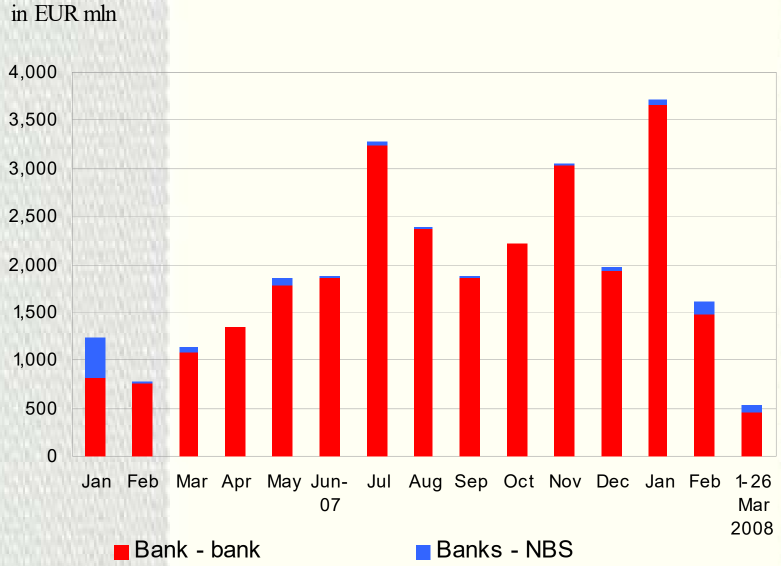
- In 2008, the dinar depreciated by 3.8%
- The rise in interest rates fails to promptly offset the effects of high risk

To increase liquidity in the IFEM, in the year to date the NBS sold a daily average of EUR 4.6 million

Foreign exchange purchase/sale by the NBS in the fixing session and euro exchange rate



Composition of banking sector trading in the IFEM in 2007 and 2008*

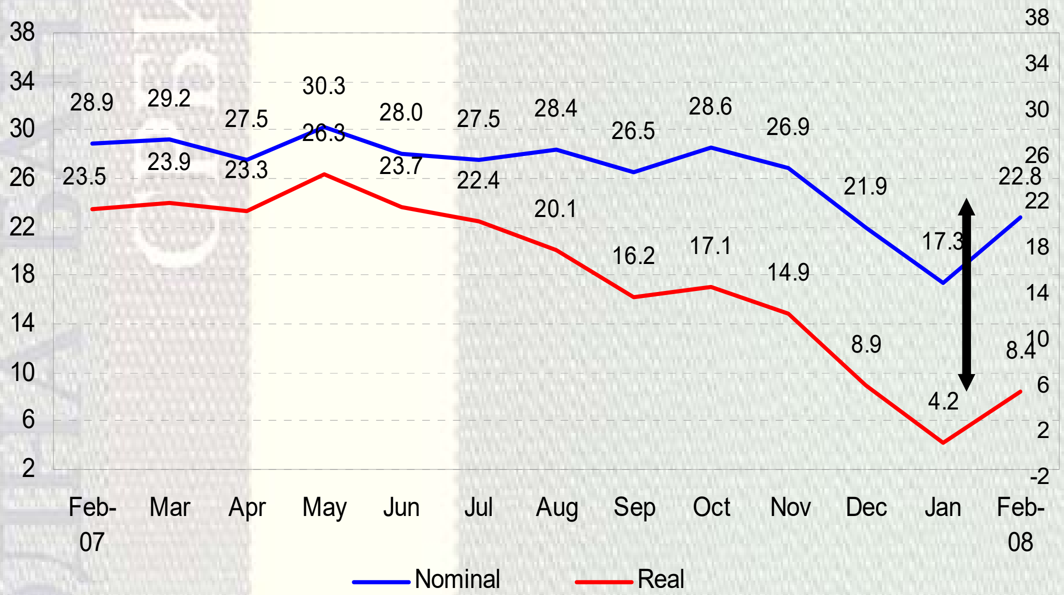


* In the IFEM, the NBS sells a portion of foreign exchange purchases from exchange dealers.

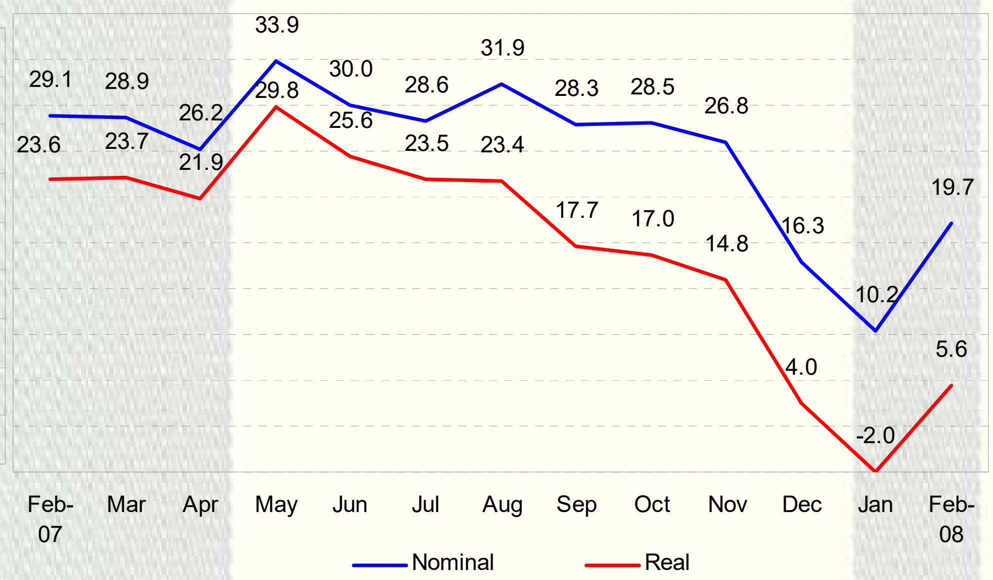
- The exchange rate is not defended in the fixing session – no fixing session has been organized for months
- In Q1 2007, the NBS sold a total of EUR 481.3 million (through the fixing session); until 28 March 2008, it sold (outside the fixing session) a total of EUR 276 million (in 60 business days)

Another round of wage increases in February

Average net wage
(year-on-year growth, in %)

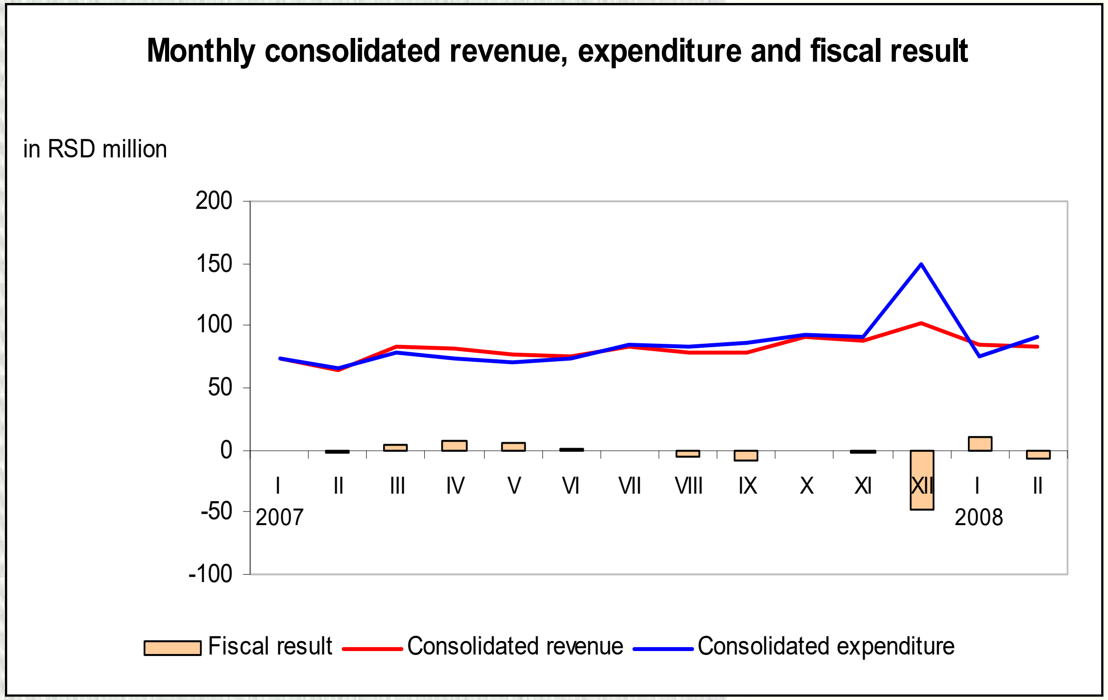


Average public sector net wage
(year-on-year growth, in %)



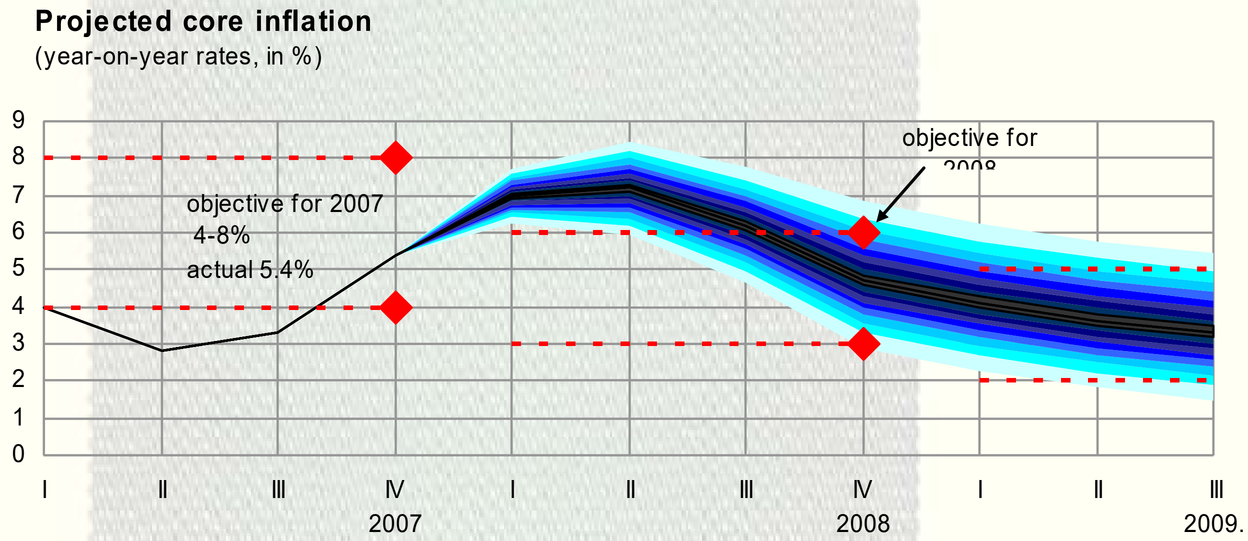
- After holding back for several months, year-on-year growth in wages picked up in February
- Real wages are not cut down by a lower wage increase but by inflation

Fiscal flows



- In February, fiscal policy eased, primarily as a result of lower income from VAT (monetary effect of around RSD 6 billion)

Core inflation objective for 2008 will be achieved



- Expected inflation outturn in Q2 2008: 1.6-2.0% core inflation and 1.9%-2.2% headline inflation
- Tighter monetary policy will help bring core inflation back within the targeted range by the end of the year (3-6%)

The state of the economy and inflationary pressures

- Current macroeconomic situation in Serbia is characterized by growing uncertainties and declining trading volumes in the commodity, money, foreign exchange and capital markets
- Main causes:
  - external: deepening crisis in the international financial markets, growth in world prices of energy, raw materials and food
  - internal: impact of political events (coming elections, European integrations, status of Kosovo and Metohija) on foreign investor attitude towards Serbia
  - rather unfavourable macroeconomic trends: widening balance of payments deficit, growth in inflation and economic slowdown

How should monetary policy respond?

- From the macroeconomic viewpoint, mild economic slowdown pinpoints inflation and foreign trade deficit as the Serbia's key areas of concern
- Tightening of the monetary policy stance can not be avoided
- The key policy rate (key monetary policy instrument) already revised upward by 300 basis points in the previous MPC meeting
- This measure alone clearly can not offset the impact of strong exogenous factors on the stability of financial markets and prices
- Though the NBS was selling EUR 5 million per day for quite a while it failed to boost trading volumes in the forex market on a more durable basis
- The NBS will continue to monitor macroeconomic developments and take additional measures in keeping with the achievement of core inflation objective as defined in May 2007 (3-6%)

New monetary policy measures

Applicable from 17 May 2008:

- Banks will be required to allocate and keep in dinars 10% of the calculated foreign exchange required reserves
- Maintenance period for required reserves will last from the 18^{th} day of the current month to the 17^{th} day of the following month
- Interest on dinar required reserves will be calculated and paid two business days after the expiration of the maintenance period
- Interest on banks' required reserves will be calculated and paid, and/or charged in the currency in which such reserves are allocated
- All calendar days of a month will be taken into account when calculating required reserves and maintaining their average balance in the maintenance period

Applicable from 1 May 2008:

- Limit on interest-bearing excess liquidity deposits (RSD 30 million) to be revoked, and interest to be paid one business day after receipt of excess liquidity deposits (instead of up to the 8^{th} day of the month for the preceding month)

Aim of new monetary policy measures

- Change in the balance sheet structure of banks (estimated effect of around RSD 28 billion)
- Increased attractiveness of dinar savings
- Growth in foreign exchange supply and stabilization of the foreign exchange market

New measures in the area of supervision applicable from 14 April...

- Mandatory 20% cash deposit for household loans will be cancelled for loans in dinars and with no foreign currency clause
- Mandatory 20% deposit on foreign currency loans - including indexed foreign currency loans – will be raised to 30%!
- No changes in respect of mortgage loans and credit card use

⇨ The aim of the above measures is not only to increase stability of the banking sector amid strong currency oscillations, but also to strengthen the transmission mechanism of the key policy rate.

... will no doubt highlight the significance of lowering inflation

- Although the inflation-induced increase in interest rate on foreign currency (indexed) loans is small, the foreign exchange risk is significant due to the fluctuations in the exchange rate.

higher inflationary pressures ⇒ higher key policy rate ⇒ higher interest rate on dinar loans

Expected effects of the new NBS measures

- Increase in the dinar share of the banking sector balance sheet total
- More realistic disclosure of household borrowing in dinars, instead in euros and Swiss francs
- Stabilization of long-term dinar yield curve
- More intense commercial bank efforts in terms of collecting dinar deposits

Thank you for your attention!