



## Current Macroeconomic Developments

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**Radovan Jelasic – Governor of the National Bank of Serbia**

**Belgrade, 24 April 2008**

# Contents

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- Inflation overview and prospects
- Financial market update
- Balance of Payments and the state of the economy
- Fiscal considerations and wages
- Assessment of macroeconomic conditions
- Recent monetary policy measures



## **MPC decided today to increase its key policy rate from 14.5% to 15.25%**

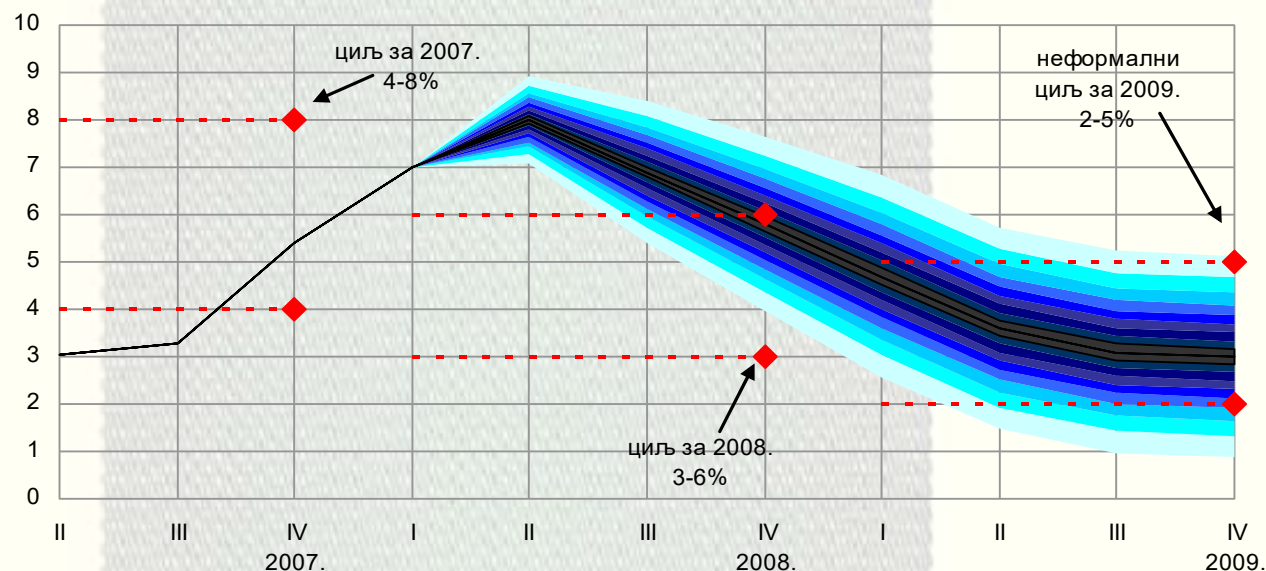
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- Inflation expectations are high and rising
- Public sector wages are growing
- The average appreciation gap is narrowing down
- Output gap is positive and will most probably remain so for most of the current year
- World oil prices are reaching new record levels and no decline in agricultural prices is expected in the near future – the spill over effect is still evident
- Political uncertainties weigh heavily

**The MPC decisions are almost exclusively based on medium and long-term projections and not dictated by daily movements in the market**

# Tightening of the monetary policy stance is unavoidable!

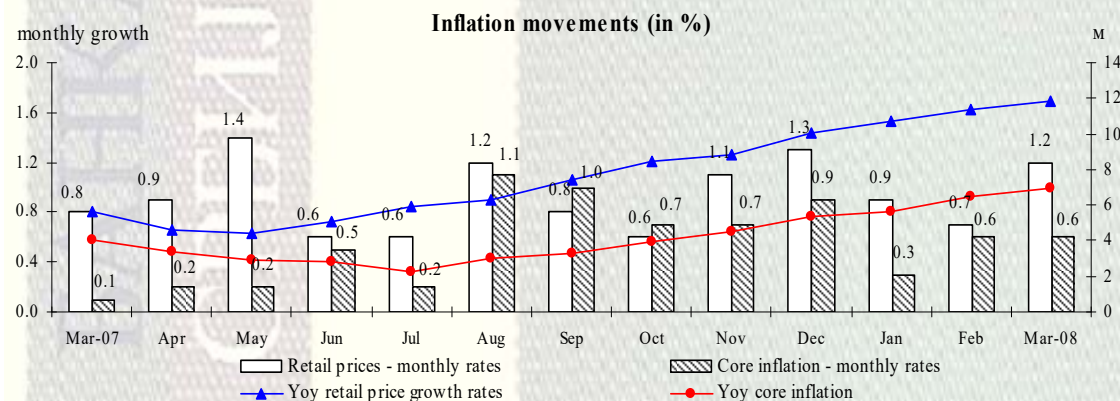
Пројектована базна инфлација  
(међугодишње стопе, у %)



- Tightening of the monetary policy stance shall contribute to the achievement of the target range for core inflation ( 3-6%) by the end of the year
- Target range for core inflation for end-2008 (3-6%) set in May 2007 is attainable



# Though year-on-year rate of inflation is increasing...



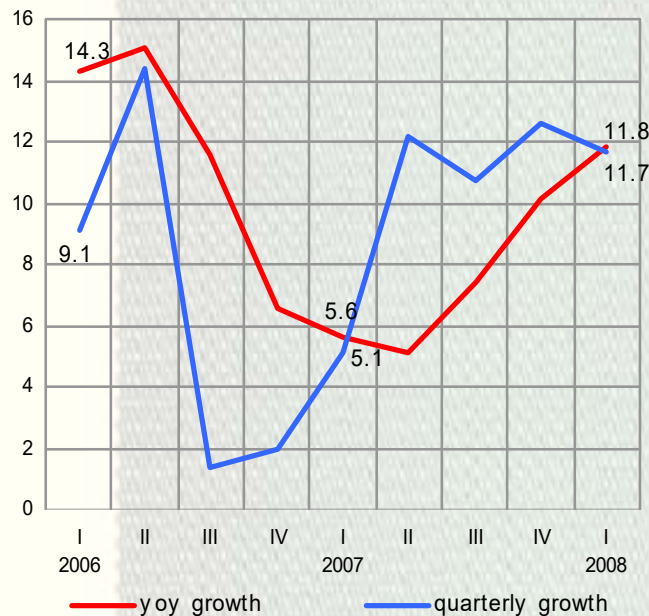
**Annual inflation rates, end of period (in %)**



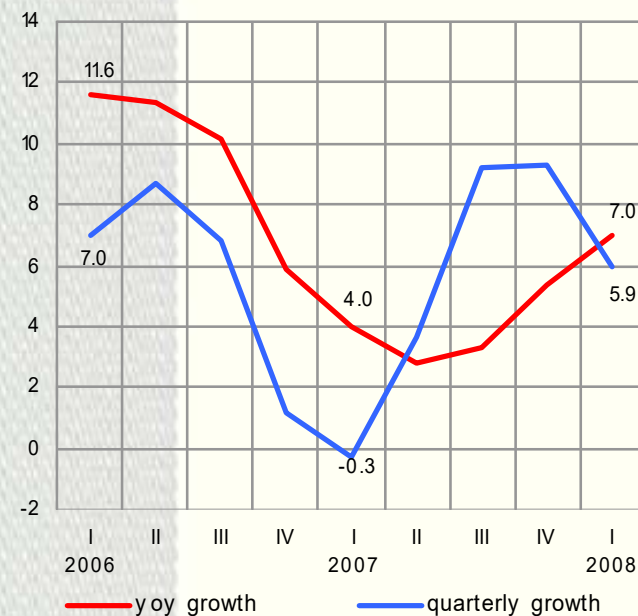
- Contribution of administrative price increases to the 11.8% retail price growth is 7 percentage points
- Year-on-year increase in consumer price index is 13.6%
- From 2009 onward, the NBS plans to target core inflation in terms of the increase in consumer rather than retail prices!

## ... core inflation rate fell in the first quarter

**Retail price growth**  
(in %)



**Core inflation**  
(in %)



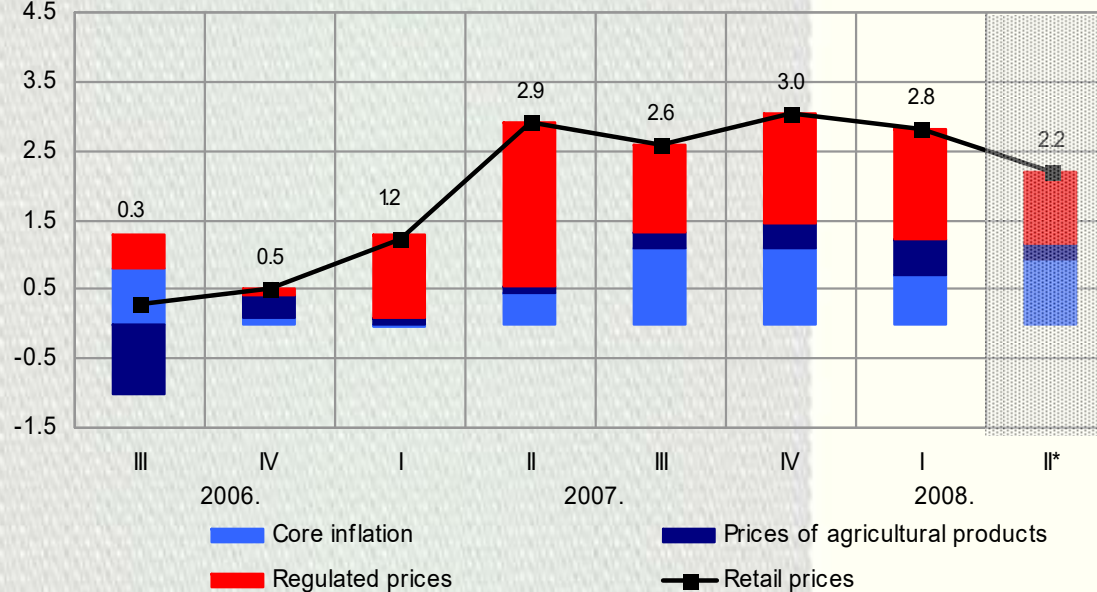
- As expected, in Q1 2008 core inflation exceeded the upper bound of the target range, (7% year-on-year) despite lower quarterly increase (1.5%) relative to a 2.2% increase in both Q3 and Q4 2007
- The Q1 increase in retail prices was 2.8% (11.8% yoy) where government regulated prices contributed 1.6 percentage points



## In the second quarter of 2008, outturn for core inflation will move further away from the target rate

Contribution to retail price growth

(in percentage points)

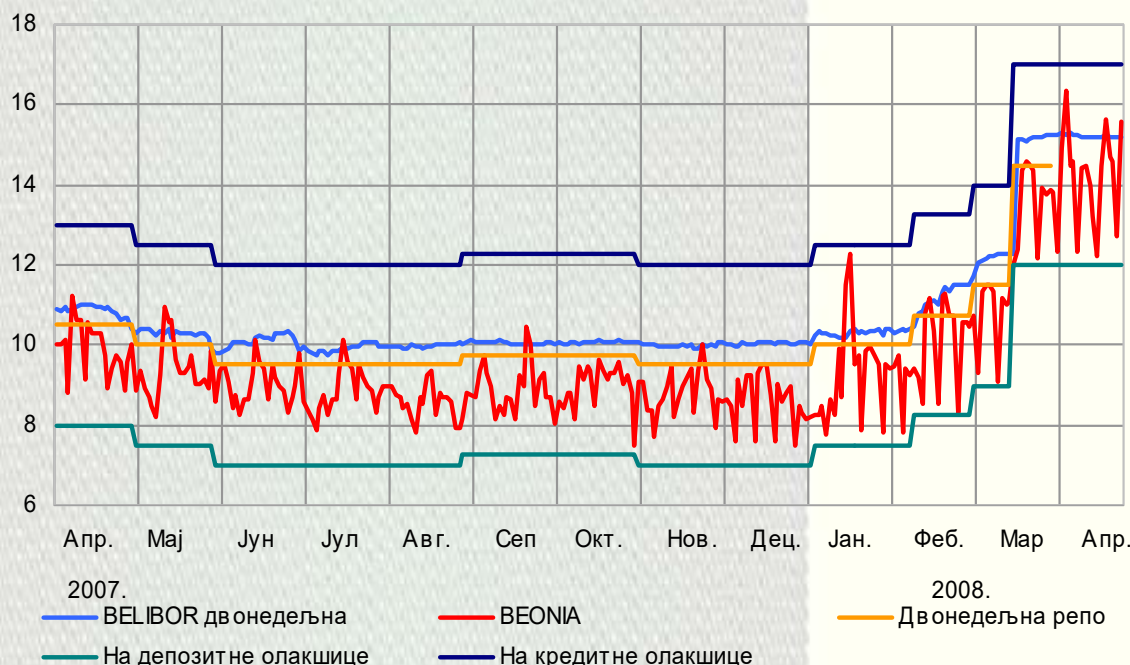


- Our assessments point to a further rise in core inflation above the upper bound of the target range and heading for 8% yoy
- Key reasons: high inflation expectations, increase in industrial producer prices, increase in energy prices, smaller appreciation gap of the real exchange rate for the dinar
- Due to the expected smaller increase in administrative prices, increase in yoy retail prices (around 11 %) will fall short of the increase in Q1 (11.8%)

## Monetary policy response to growing inflationary pressures in Q1 is a 450 basis point increase in the key policy rate

Interest rate movements in 2007

(daily data, annualized, in %)

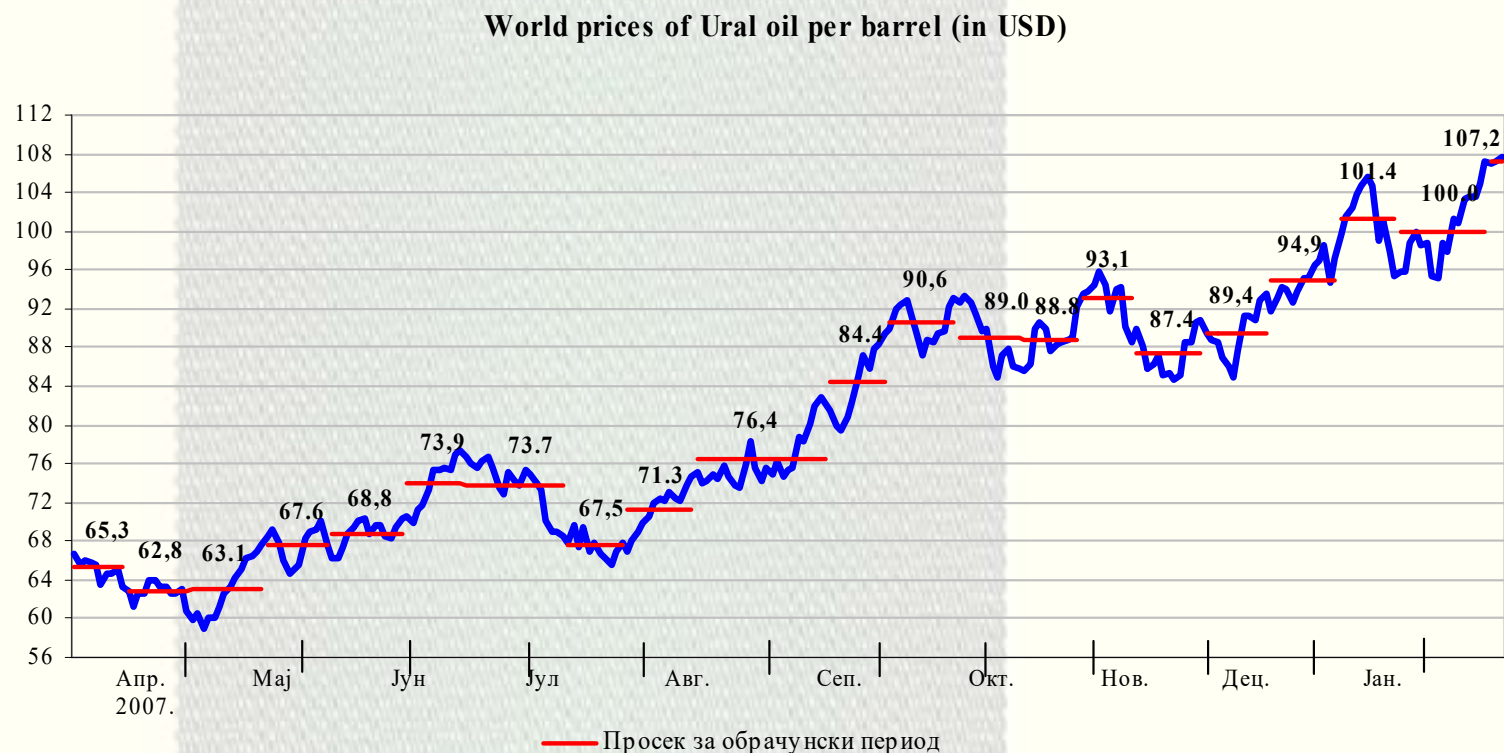


Source: NBS and Reuters.

- Money market interest rates as well as bank lending and deposit rates reflect movements in the NBS key policy rate
- Changes in lending rates were more reflective of changes in the key policy rate than the deposit rates and resulted in higher interest rate margin in March
- Steeper slope of the yield curve points to a further increase in inflationary expectations

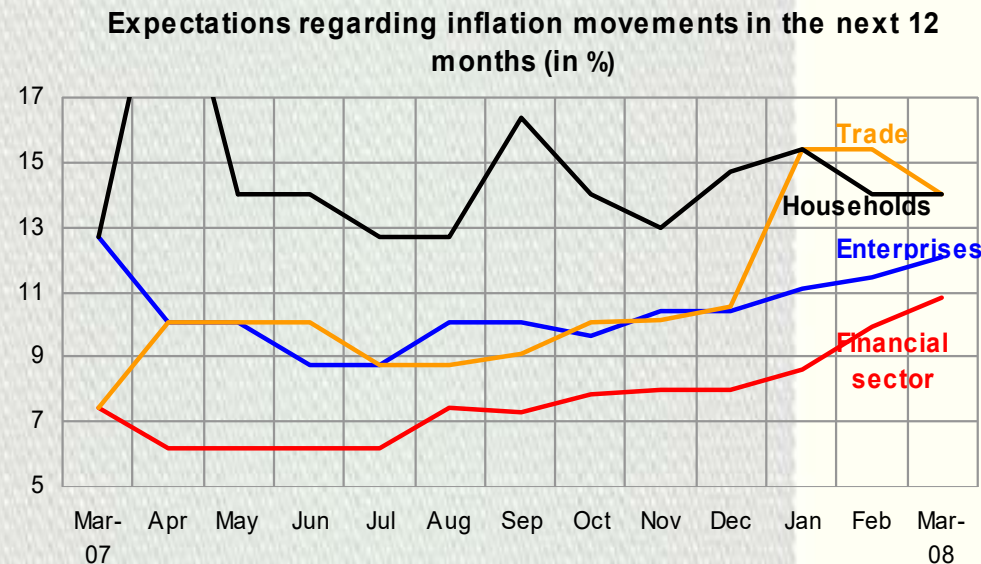


# Oil prices set to increase further



- The increase in world prices of oil continues: in the second half of April, the price of Ural oil reached USD 109 and the price of Brent oil USD 115 per barrel
- Estimates of future movements in oil prices are shaky – the only moderating factor is a weaker dollar

# Inflation expectations rose in 2008



Source: Survey (TNS Medium Gallup).

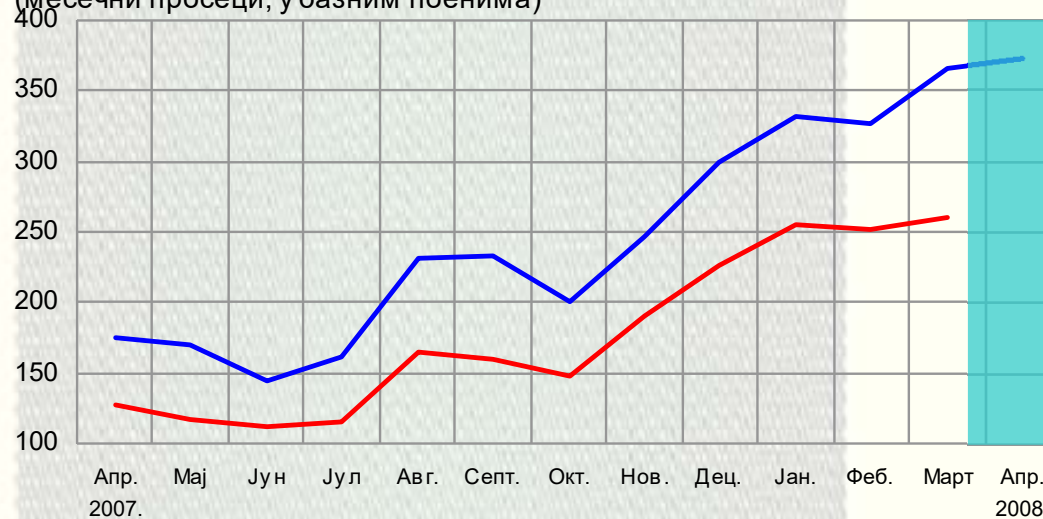
- The key factor contributing to the acceleration of inflation
- Inflation expectations of the financial sector for the next 12 months rose in March by 1 percentage point to 10.9%
- Inflation expectations are not easily controlled and, like prices, display downward rigidity



# Increased investment risk in transition countries including Serbia

## Показатељи премије ризика за Србију- EMBI\* и CDS\*\*

(месечни просеци, у базним поенима)



Извор: JP Morgan.

\*) **EMBI** је разлика у приносу на државне обвезнице САД и Србије на међународном тржишту

\*\*) **CDS** је credit default swap

- Reluctance of foreign investors mainly due to deepening crisis in financial markets and domestic political uncertainties
- The risk premiums rose further in April

## Movements in capital markets: stock exchange indices show further drops

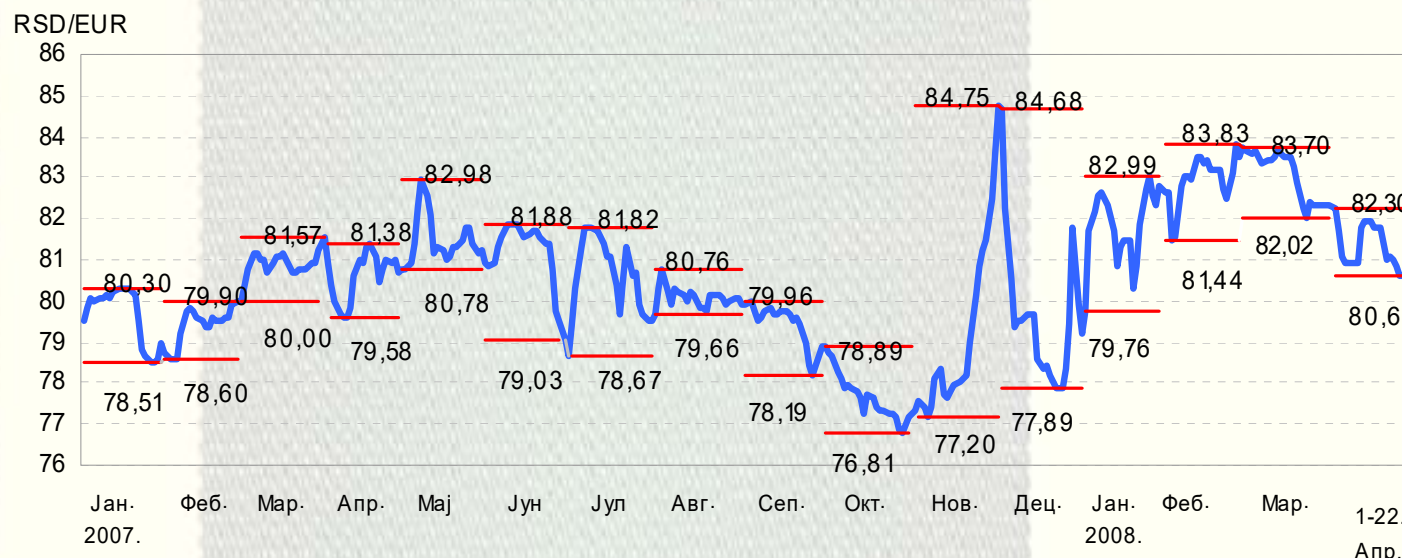


- Stock exchange indices Belex 15 and Belexline continued declining in April
- In the first 15 days of April, index of the most liquid shares (Belex 15) lost about 7.9% of its value and fell to its lowest level since December 2006
- Similar developments were also recorded in other countries of the region



## In April to date, the dinar appreciated by 2.4%

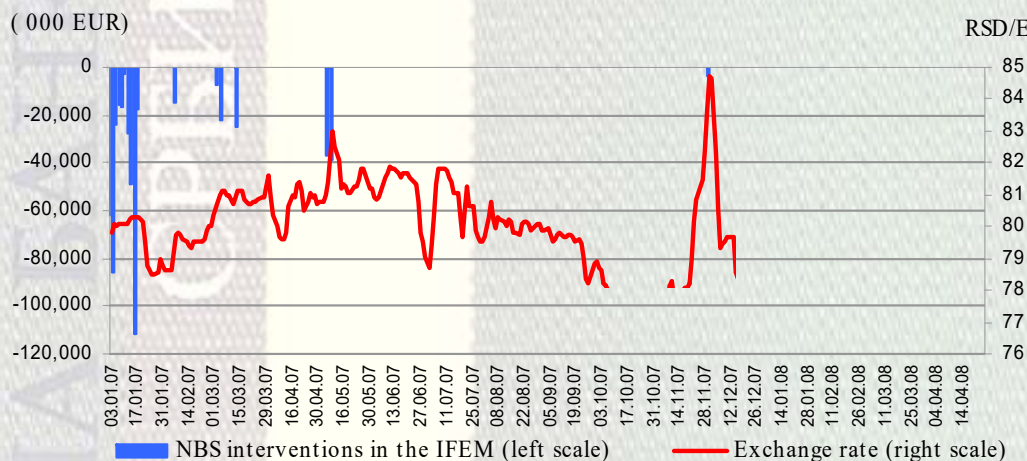
Movements in the RSD/EUR exchange rate in 2007 and 2008



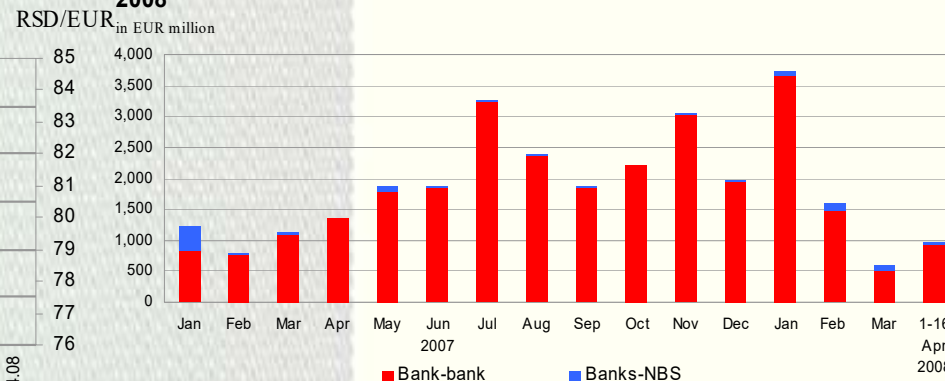
- As trading volumes fell and the dinar strengthened, the amount of foreign exchange that the NBS sells to commercial banks on a daily basis out of its purchases from foreign exchange dealers, declined from EUR 5 million to EUR 3 million and down to zero since yesterday (the volume of trading in the IFEM was EUR 134.9 million on 23 April)
- As expected, the increase in interest rates cancelled off the impact of increased

# To boost liquidity levels, the NBS sold an average of EUR 4.7 million per day in the IFEM this year

**NBS fx trading at the fixing session and exchange rate of the euro**



**Structure of banking sector trading in the IFEM in 2007 and 2008\***



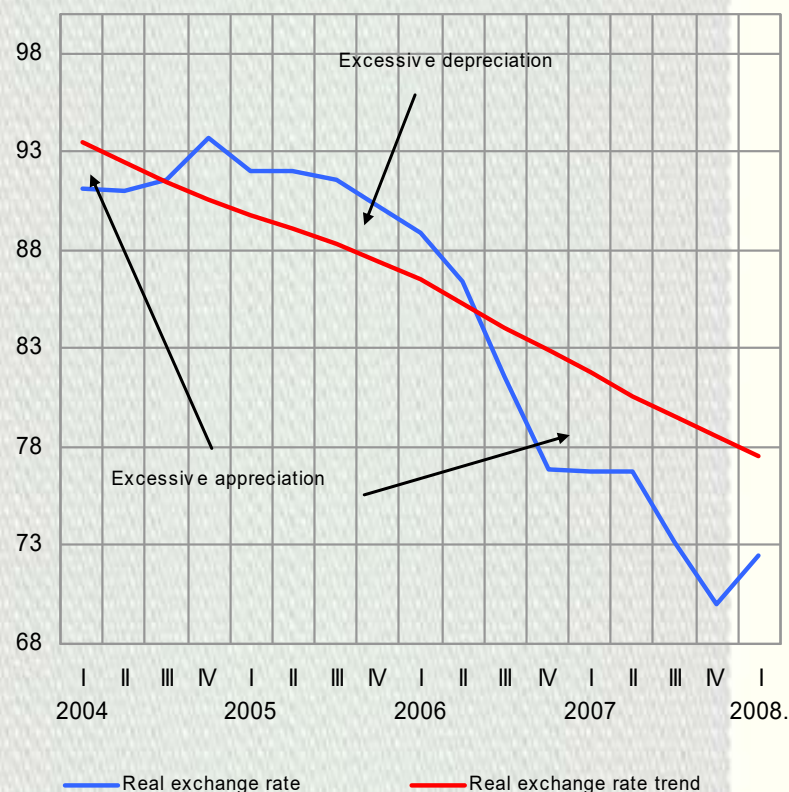
\* NBS sells in the IFEM a portion of foreign exchange purchased from exchange dealers.

- Exchange rate level has not been defended in fixing sessions since mid-May 2007
- From the beginning of the year (73 business days) the NBS sold a total of EUR 343 mln (outside the fixing session), in contrast to EUR 481 mln in the same period a year earlier (in the fixing session) - 40% more!



## Disinflationary pressures from the appreciation gap are subsiding

Real exchange rate and its trend

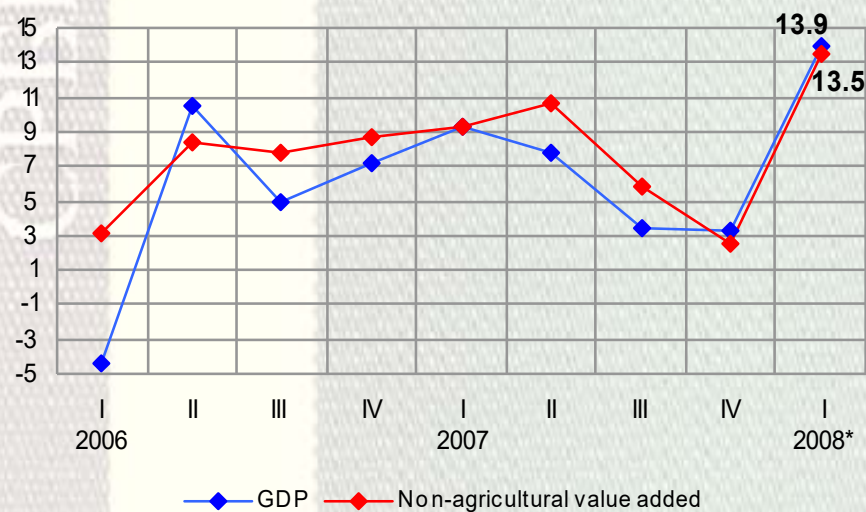


- Open appreciation gap played a significant role in the process of disinflation in the preceding period
- Disinflationary pressures arising from the appreciation gap have been subsiding in the first quarter of the year

# Economic activity stepped up in Q1

## Growth in economic activity indicators

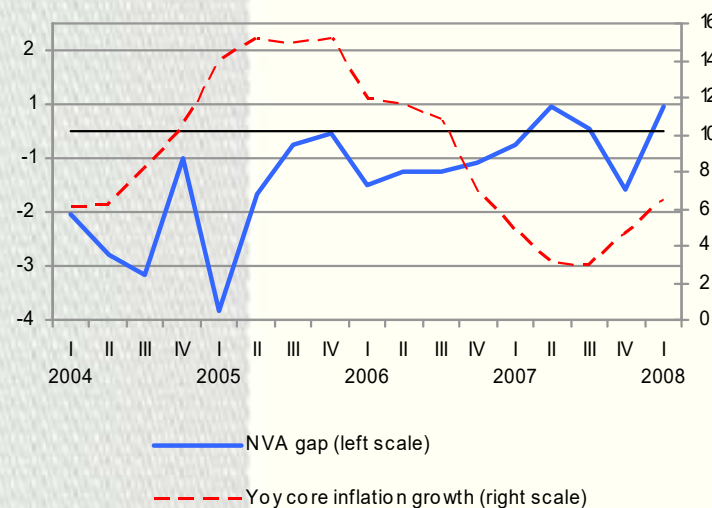
(seasonally adjusted quarterly growth rates, at annual level)



\* NBS estimate.

## Output gap and core inflation

(yoy, average-on-average)

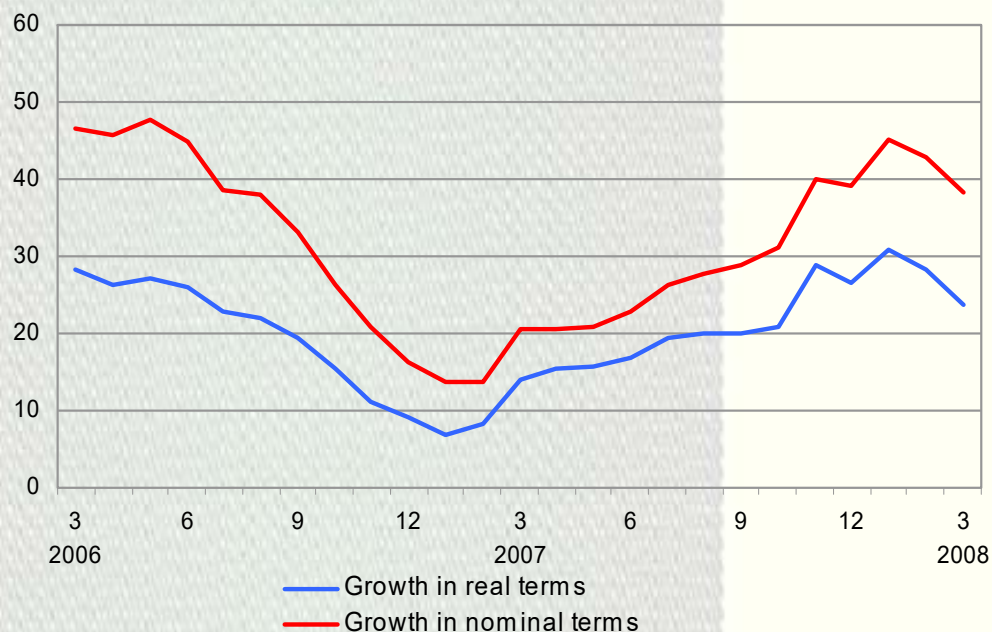


- Economic activity stepped up and recorded strong growth in Q1
- Output gap turned positive – growing inflationary pressures in respect of aggregate demand



## Commercial bank lending experienced a mild decline

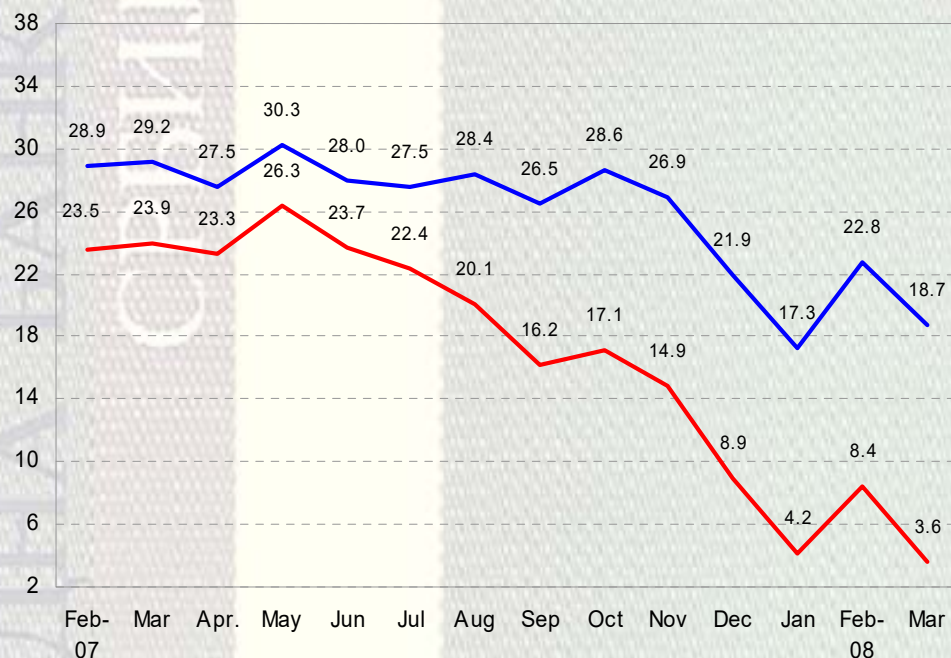
Yoy growth in lending to households and enterprises  
(in %)



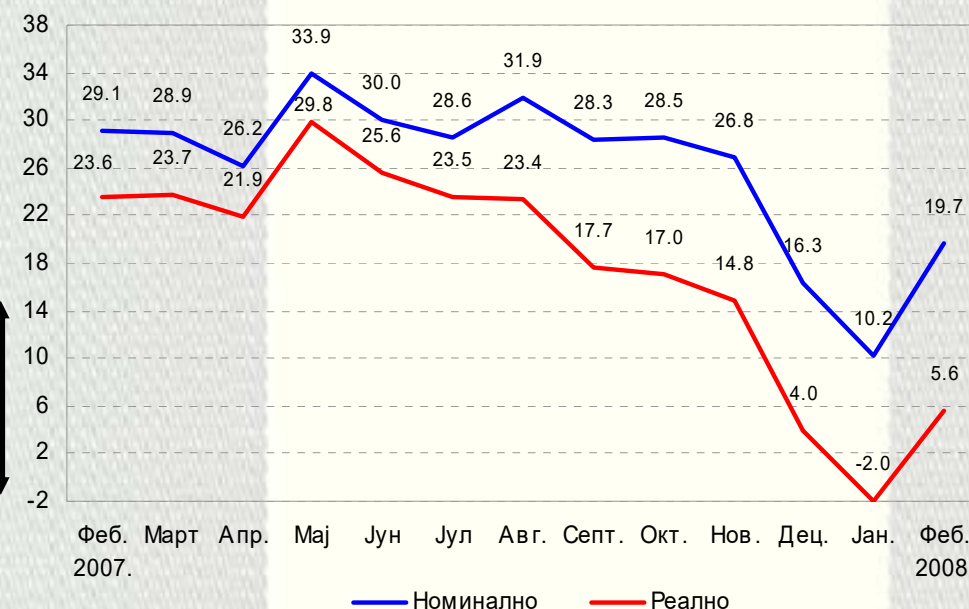
- Although bank lending activity slowed down mildly in February and March, it remains relatively high – the strongest growth was recorded for housing construction loans

# After substantial growth in February, wages slowed down in March

**Average net wage**  
(yoy growth, in %)



**Average net wage growth in the public sector**  
(yoy growth, in %)

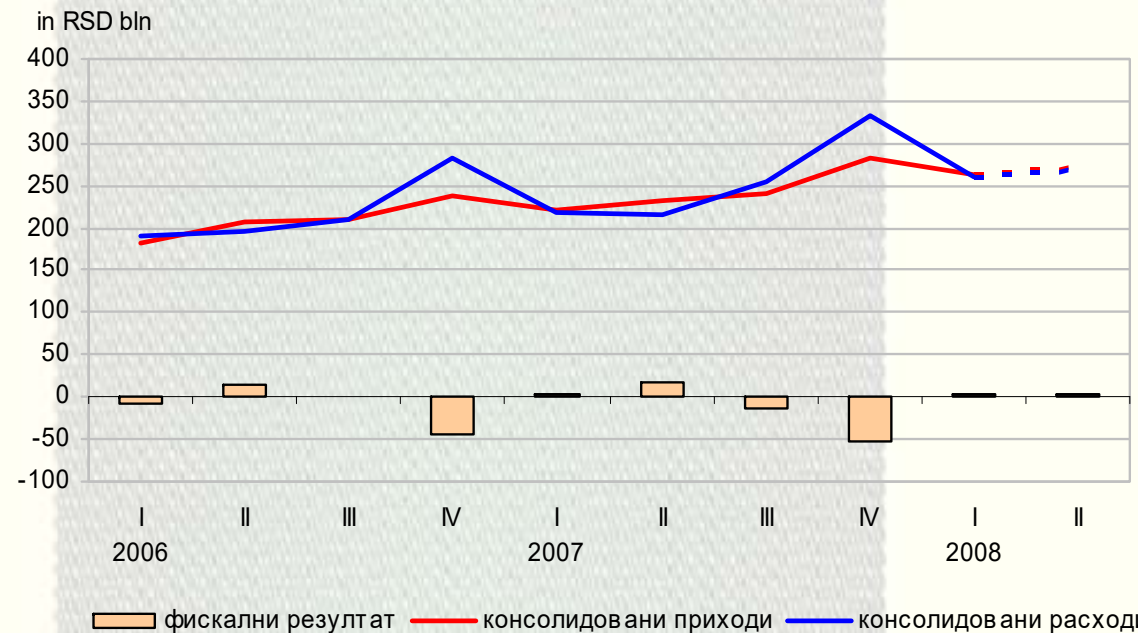


- Year-on-year wage growth slowed down in March
- The truth is that real wages are not diminished by smaller wage increases but by inflation
- The announced upward revision of wages in April will fuel growth in domestic demand!



# No major changes in fiscal developments since December!

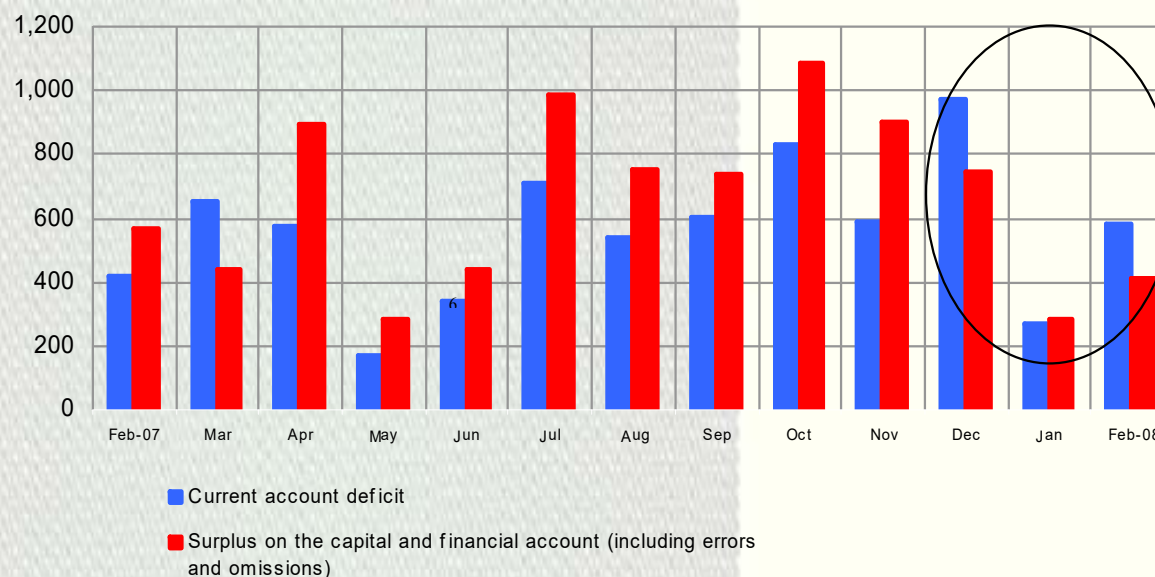
Quarterly consolidated revenue, expenditure and fiscal result



- Tightening of fiscal policy in Q1 (resulting in the withdrawal of RSD 4.8 bln according to the IMF methodology) was partly seasonally-induced (collection of profit tax, collection of VAT on December trade in January)
- A much more expansive fiscal policy stance is expected in the second half of the year

# Balance of payments is deteriorating

**Current account deficit and net capital inflow**  
(in USD mln)

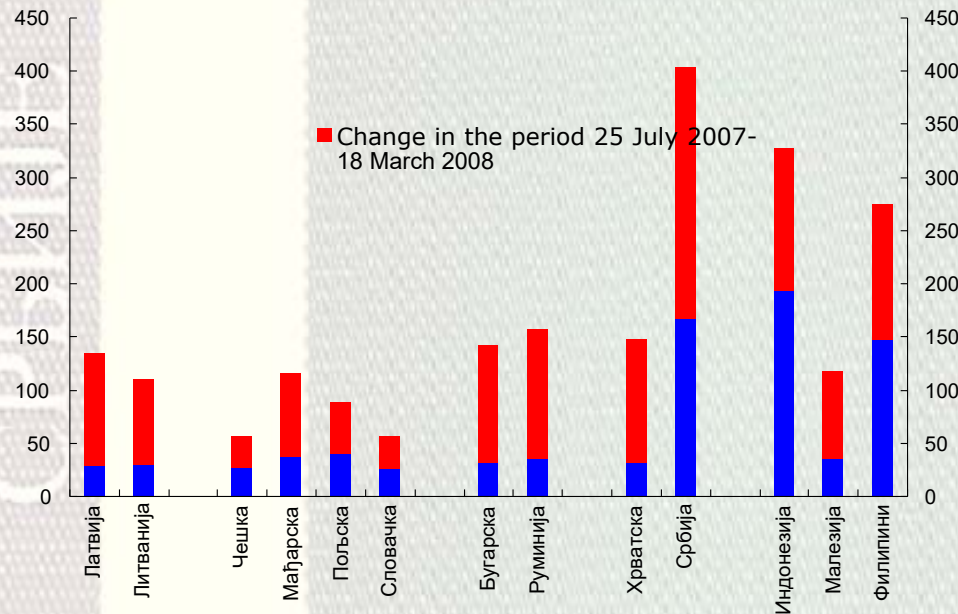


- Net capital inflow was not sufficient to cover the current account deficit in February
- Hence, foreign exchange reserves witnessed an outflow of USD 172.2 mln (inter-currency changes excluded);
- In March, net capital inflow exceeded the current account deficit by USD 79 mln.



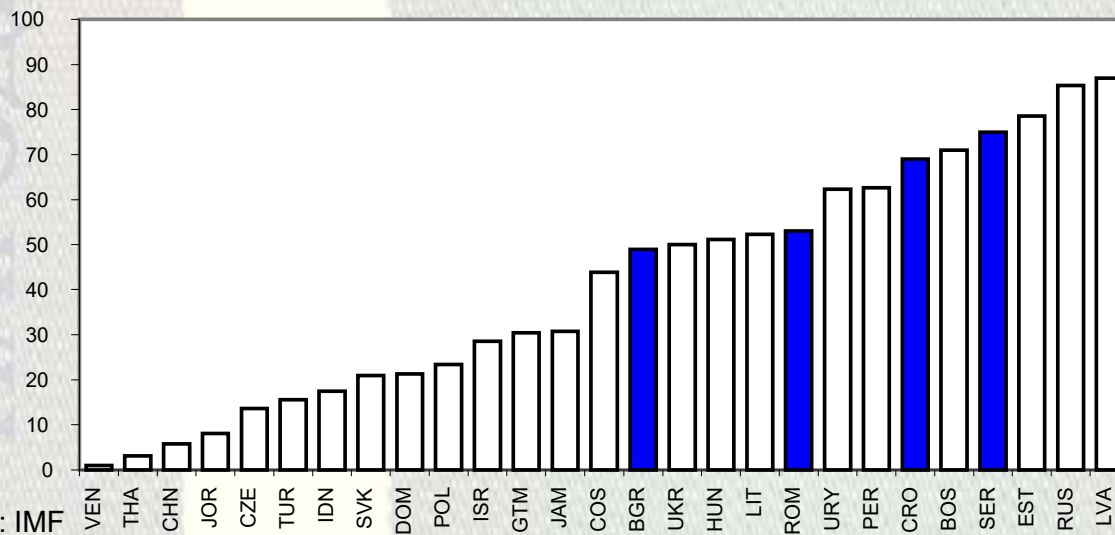
# Our country risk premium significantly increased over the past 9 months

Basis points



Source: IMF

Share of f/c clause-indexed loans in total lending in 2007



Source: IMF

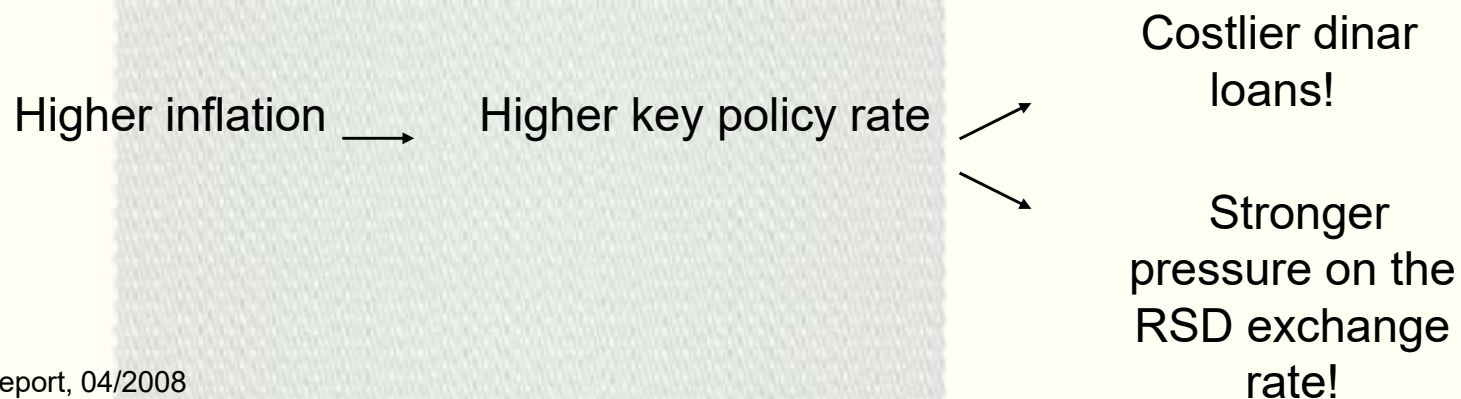
- Financing of the current account deficit – reliant in 2007 mainly on borrowing, rather than FDIs – will become less affordable and less accessible!

- Structure of lending is made more complex by high level of euroization of banks' balance sheet totals.

## Both international and domestic risks are rising steadily!

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- Current crisis of the financial sector is the most serious one since World War II – the Global Financial Stability Report\* estimates potential losses at around USD 945 billion
- Economic circumstances in Serbia are deteriorating further - country rating was downgraded from BB- positive to BB- negative
- Hence, those who borrow in foreign currency are exposing themselves to an even greater exchange rate risk in the future!
- It is irresponsible, unprofessional and contrary to good business practice to promote loans in foreign currency playing on the card of “lower interest = cheaper loan”





## World Bank suggestions regarding growth in prices of energy and agricultural products

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- To alleviate pressure on the most disadvantaged part of population by raising social benefit payments. To restructure public expenditures so as to create scope for additional social benefit payments.
- To avoid restrictions on exports as they inevitably disrupt future investment in agriculture, particularly in view of the forecast continuation of food price growth.
- Regulatory authorities should focus on inflation management and strive towards establishing free trade mechanism to enable entirely market-based formation of food and energy prices.

# Financial derivatives: concept and examples

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- Types of risk
- Hedging
- Foreign exchange forward deals
- Currency swaps
- Interest rate swaps
- Cross currency swaps
- Options



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**Thank you for your attention!**