Key determinants of price movements in Serbia – empirical review of nine transition years

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“Macroeconomic” transition in-between the legacy, expectations and financing prospects

- Macroeconomic model of stability and growth was based on high inflow of FDIs and foreign credits (about EUR 25 billion since 2001) – economic growth was in its major part related to non-tradables;
- Results of the application of this model are evident in high rates of growth in a) GDP, b) standard of living, c) investment, but also in a) high deficit on the current account of the balance of payments, b) stronger link between economic activity and domestic demand, c) comparatively high inflation, all of them pointing to its long-term unsustainability;
- With the decline in foreign inflows in a crisis environment, the adjustment of aggregate demand was “compulsory”;
- Sustainable growth assumes an increase in export supply and/or investment demand in response to a cut in domestic demand (current spending);
- A positive impact of the exchange rate on exports can only be expected if backed by a pro-active public sector income policy, which would lessen the depreciation pressures on inflation – much has been done in 2009, but what does 2010 hold in store for us?

Prices of goods and services in Serbia are determined by demand and supply as well as by expectations

Demand	Supply

Demand

- Consumer demand: wages, pensions, social transfers, remittances and other items of household income less net saving and net investment;
- Investment: FDI, domestic and foreign borrowing...;
- Government spending;
- Net exports: exports less imports of goods and services.

Supply

- Production potential;
- Factor productivity;
- Factor prices:
  - interest,
  - wages,
  - import prices,
  - taxes.

- Households continue to be net creditors, while the economy remains a net debtor.
- The gap between sources of inflow and outflow of funds is increasingly bridged by borrowing (up by EUR 1.4 billion in 2009) relative to financing from privatization receipts.

Three different phases of monetary policy in Serbia over the last nine years

October 2000 — **I Stabilization**

- Exchange rate as a nominal anchor;
- Price liberalization;
- Brake on automatic monetization of fiscal deficit;
- Ongoing presence of the NBS in interbank forex market.

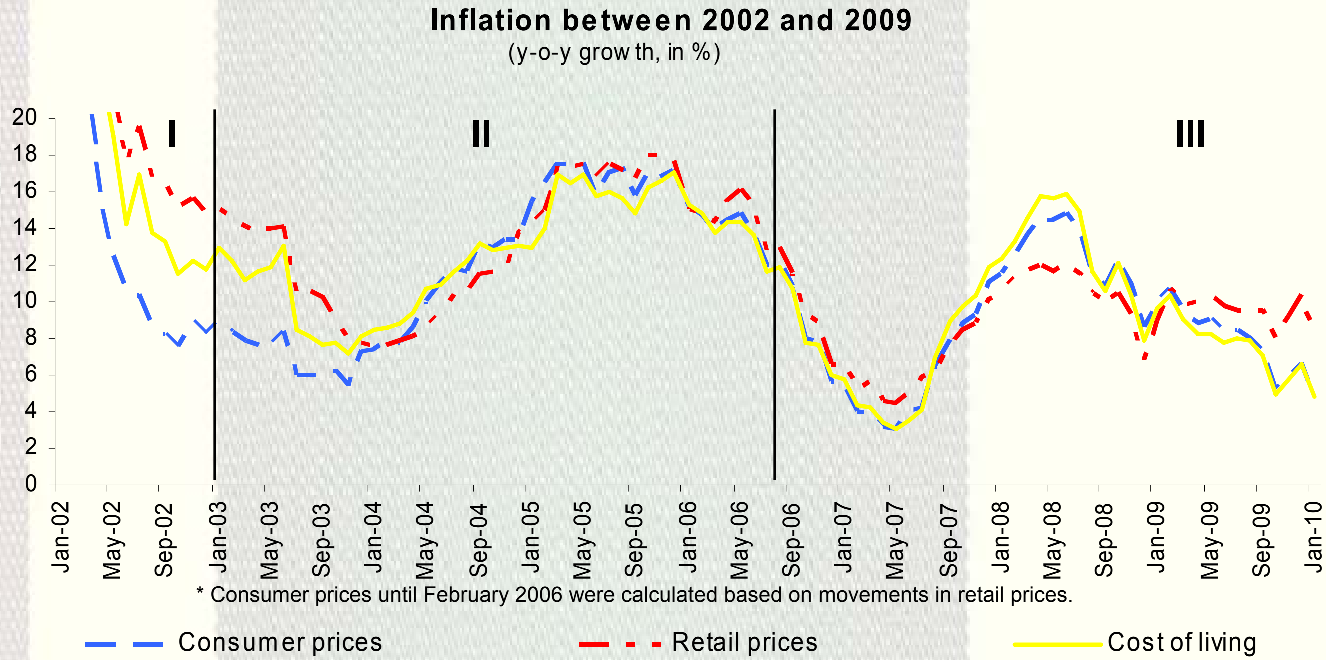
2003 — **II Exchange rate targeting**

- IMF supported program;
- Maintenance of a stable real exchange rate for the dinar – programmed depreciation of the dinar;
- Monetary sterilization via open market operations.

August 2006 — **III Inflation targeting**

- Rate of inflation as a single numerical target;
- Key policy rate as the key monetary policy instrument;
- Exchange rate as a monetary policy indicator – a result, not a target;
- Increased transparency of monetary policy.

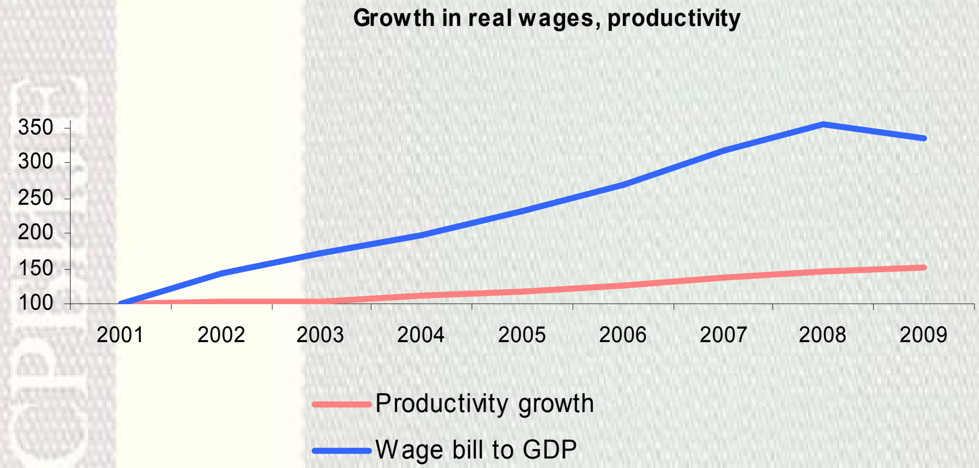
Inflation varied significantly between 2001 and 2009

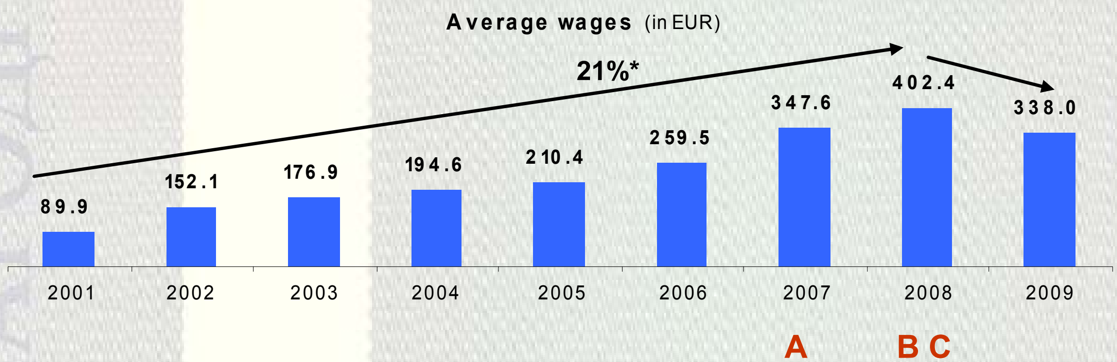


Movements in inflation relative to the disinflation path were mainly determined by:

- Demand side shocks: abrupt adjustments in public sector wage and pension payments;
- Parity adjustments in regulated prices, particularly pronounced until mid-2005;
- Supply side shocks (food prices): creating inflationary pressures in 2007/2008 and deflationary pressures in 2008/2009;
- External shocks (import prices of primary products, oil in particular): creating inflationary pressures in 2008 and deflationary pressures in 2009.

Slower growth in productivity relative to WAGES during nine transition years





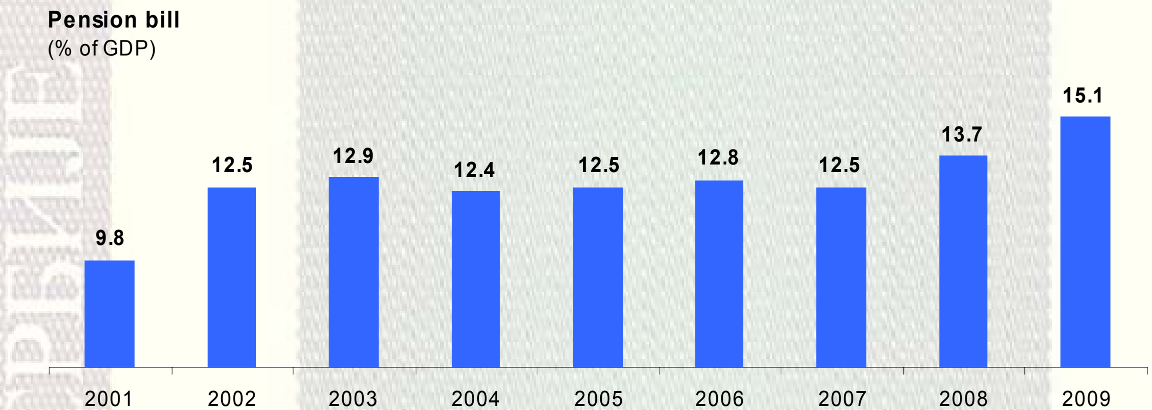
*cumulative annual rate of growth

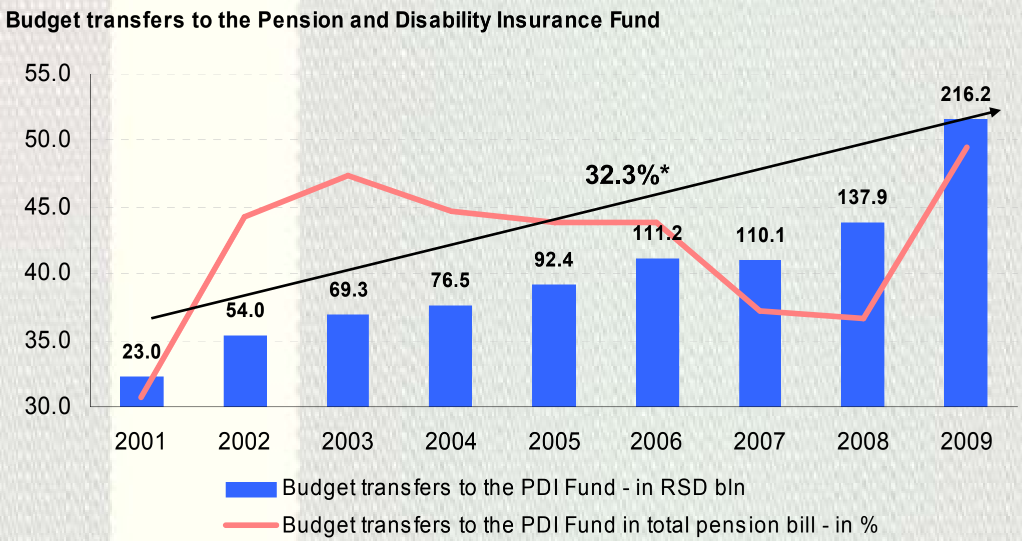
- By end 2008, gross wage bill more than tripled as a share in GDP. First signs of a decline appeared in 2009;
- Wage movements as the outcome of impending elections:
  - 2007= +34%
  - 2008= +16%

Elections:

A – parliamentary	1 / 2007
B – presidential	1 / 2008
C – parliamentary	5 / 2008

Higher PENSIONS were financed by budget transfers

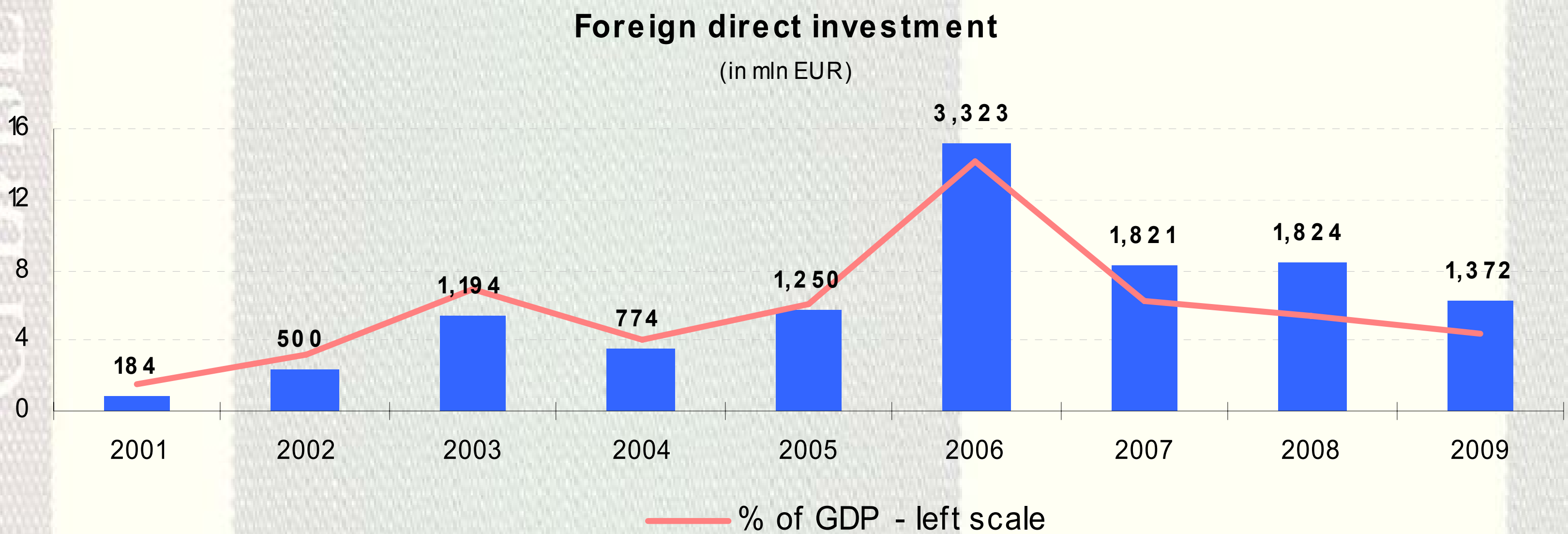




*cumulative annual rate of growth

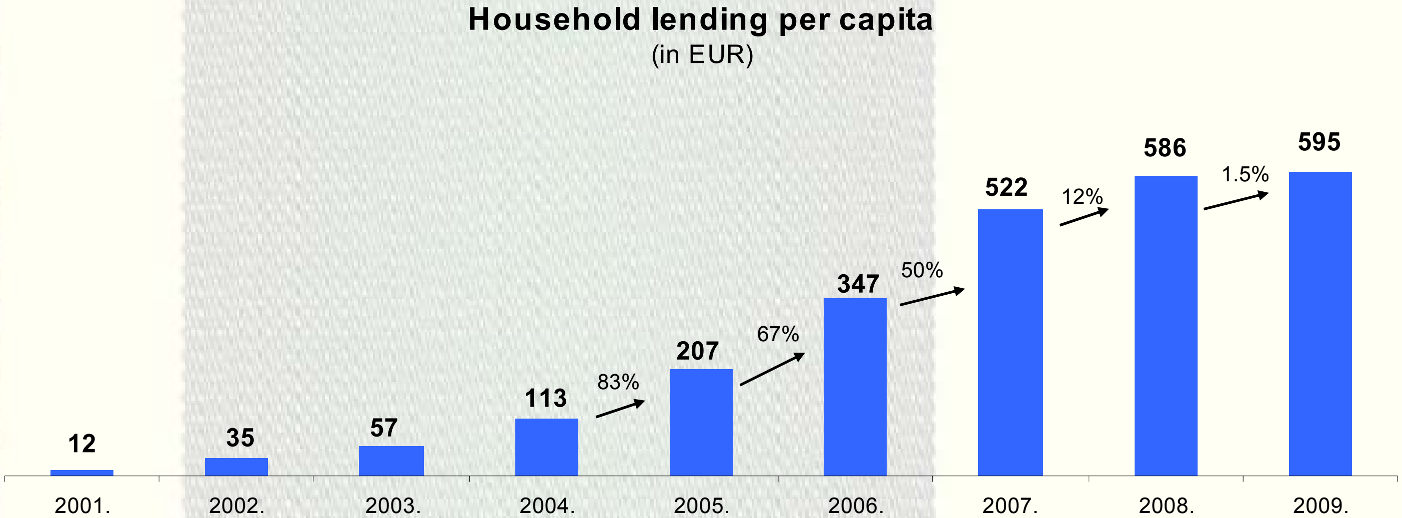
- Budget transfers for payment of pensions "devoured" a fair portion of the budget!;
- Under current IMF supported programme the share of pensions in GDP should decline to 10% by 2015;
- Linking pensions to CPI under the IMF supported programme in 2004 contributed to stabilization of the share of pensions in GDP (a decrease in 2007).

FOREIGN DIRECT INVESTMENT amounted to EUR 1.4 billion per year, on average



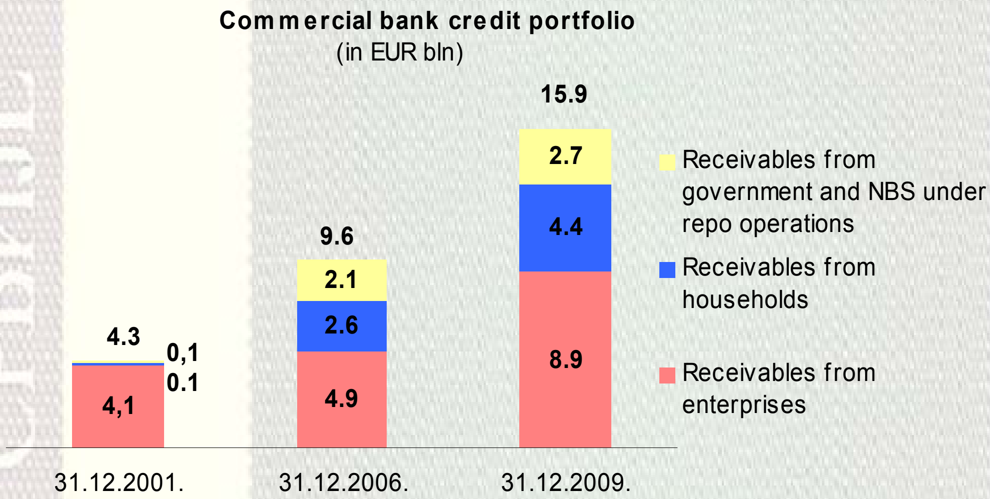
- Net FDIs over nine transition years totalled EUR 12.3 billion;
- Of which, budget inflows from privatization receipts came to around EUR 5.1 billion (on a cash flow basis).

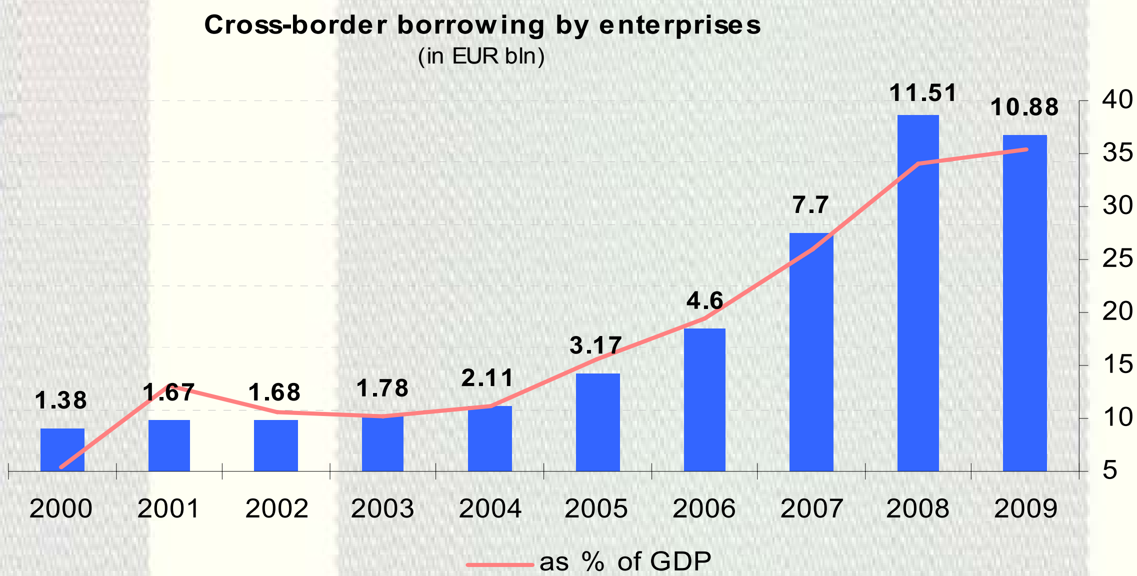
The crisis halts accelerated growth in LENDING TO NATURAL PERSONS!



- Total bank lending to households at end-2009 came to EUR 4.32 billion (of which, 24% in dinars and 26% in euros);
- Total increase in lending to natural persons between 2002 and 2009 amounted EUR 4.1 billion.

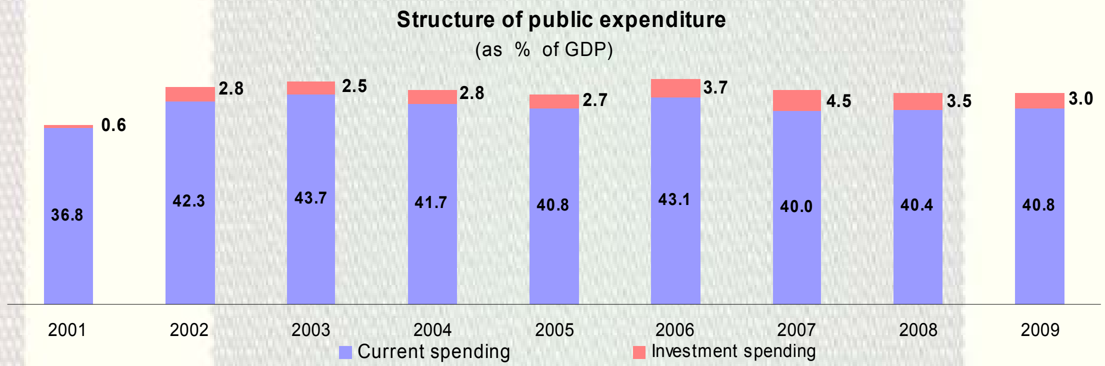
Until 2009, ENTERPRISE LOAN PORTFOLIO was augmented both from domestic and foreign sources

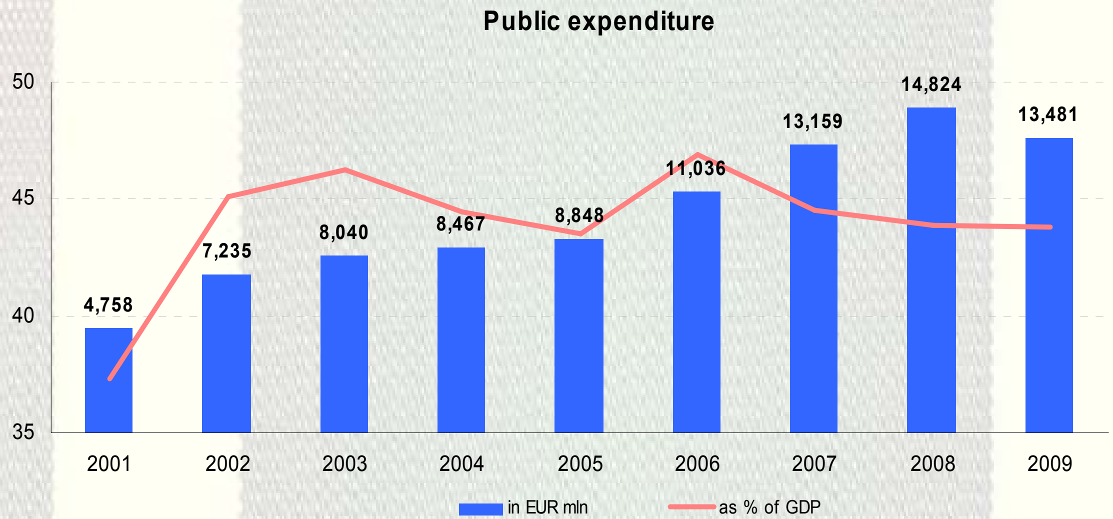




- The volume of direct borrowing abroad depended on the degree of monetary tightness;
- Though loan portfolios of Serbian banks rose in 2009, the volume of cross border borrowing decreased to EUR 620 million;
- Indebtedness of banks at end-2009 was EUR 4.6 billion against EUR 10.9 billion of other enterprises.
- The ratio of foreign relative to domestic lending by banks varied substantially during transition years!

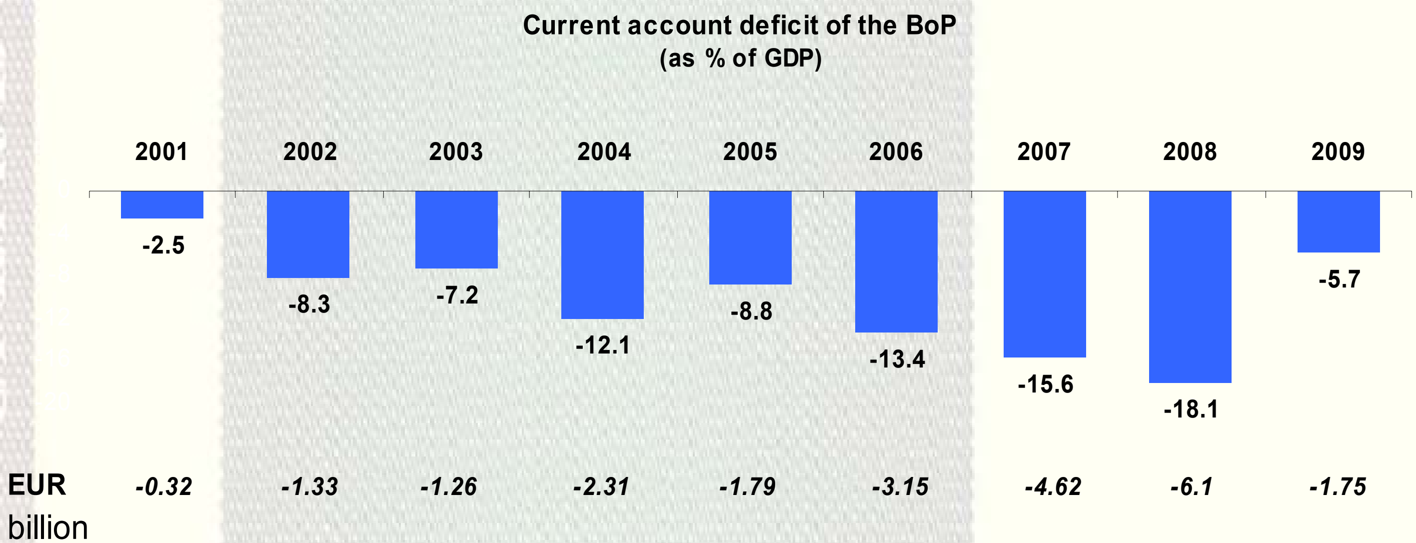
PUBLIC EXPENDITURE did not decline even in years of high inflow of private capital





- The current structure of public expenditure does not ensure sustainable economic growth in the longer run;
- The share of investment spending remained low even in years of high inflow of privatization receipts.

Current account of the balance of payments was sensitive to all demand side pressures



- The current account deficit narrowed by EUR 4.35 billion, which is significantly more than expected;
- In 2009, capital inflows and FDIs in particular were higher than the deficit on the current account of the balance of payments. This led to the accumulation of foreign exchange reserves and rendered spending of funds disbursed under the IMF loan unnecessary!

“Pass-through” effect of the exchange rate on prices is a well known fact...

- “Pass-through” effect of the exchange rate – direct and indirect effect of exchange rate related shocks on domestic prices.
  - Channel of direct influence: changes in prices of imports and inputs (cost-push inflation);
  - Channel of indirect influence: influence on net exports and change in aggregate demand (demand-push inflation).
- Analysis of the pass-through effect for Serbia*:
  - In the short-run, 0.2-03 (in the current quarter);
  - In the medium run, around 0.6 (up to a year).
- The above analysis of the “pass-through” effect estimates the potential impact of the exchange rate on prices without taking other factors into account!

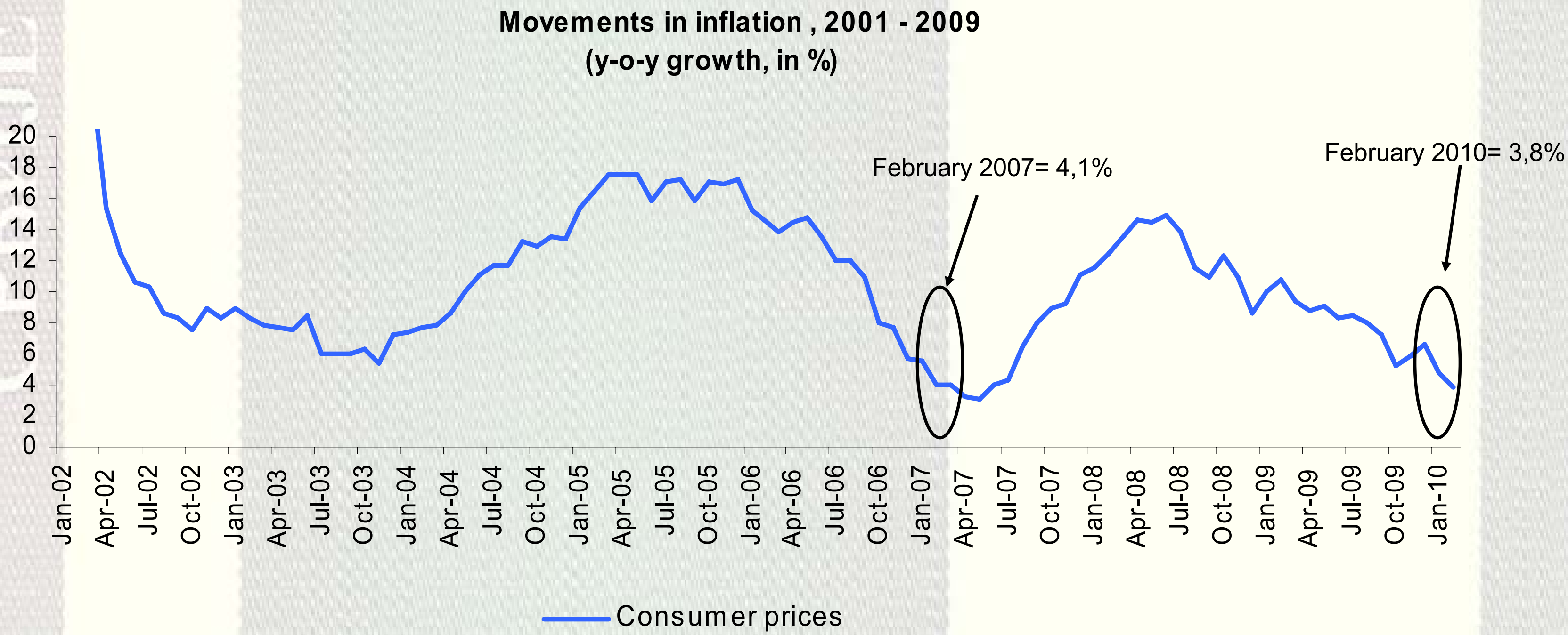
*NBS (2007,2008), Mladenovic et al. (2007)

... but its ultimate impact on prices depends on many other macroeconomic factors!

The overall impact of nominal depreciation of 30% (24% from September 2008 until February 2009) on the 2009 inflation was neutralized to a large measure by:

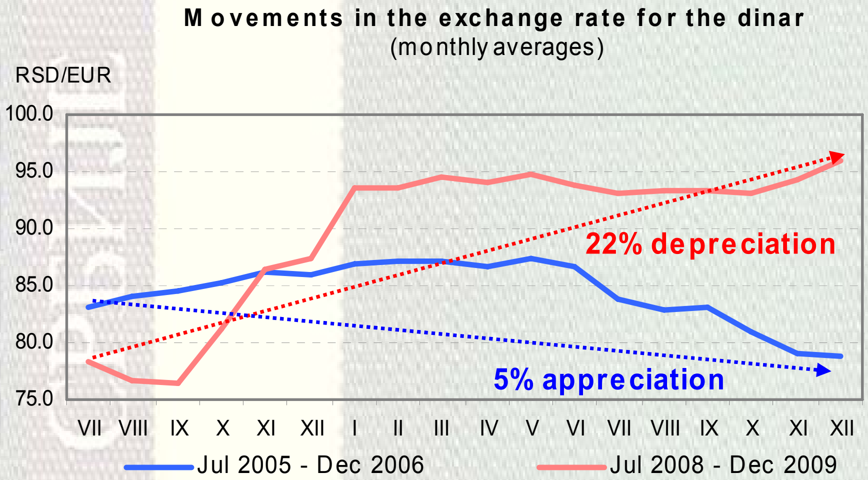
1. Substantial decline in aggregate demand (lower credit demand, less FDIs, higher saving, etc.);
2. Lower sources of income (freeze on wages and pensions, decline in employment);
3. Lower prices of oil and other primary commodities;
4. Significant decline in foreign trade caused by the decline in world demand;
5. Lower inflation expectations;
6. Lower public consumption ...

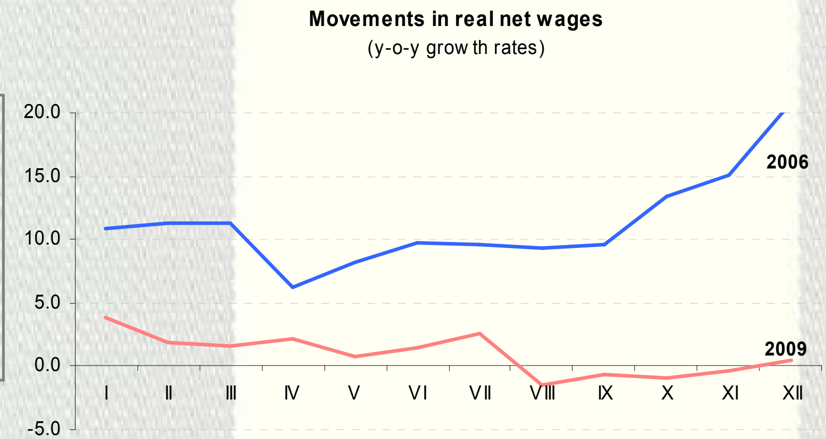
In terms of movements in prices, Serbia is experiencing a deja-vu ...

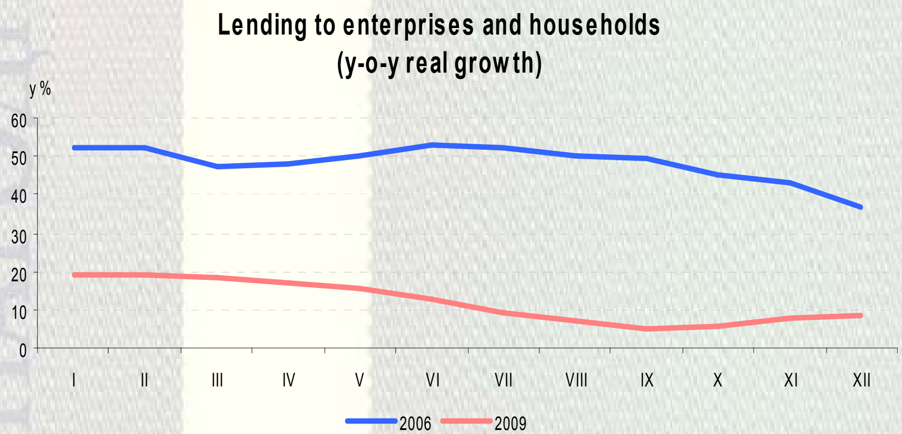


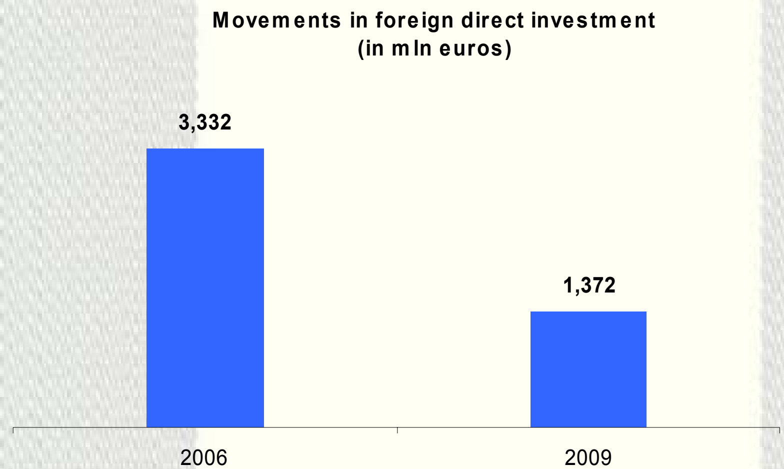
- In early 2010, y-o-y inflation in Serbia was close to that recorded three years ago!

... but other conditions differ substantially









What kept inflation in 2009 within the planned range?

- Regulated price growth of 15.5%;
- Depreciation of the exchange rate for the dinar by 25%.

- Lower domestic and foreign demand;
- Lower world prices of oil and other primary commodities;
- Freeze on public sector wages and pensions;
- Lower inflation expectations ...

6.6%

Though 2010 is not likely to match the year 2006...

- The key difference is in reliance on external demand to induce higher growth, while the increase in domestic demand will be slowed down by scarce funding:
  - Bank lending in Serbia will increase slightly (negligibly);
  - Cross-border borrowing will at best remain on the last year's level;
  - FDIs will be scarce (according to the projection, EUR 1.4 billion in 2010 and EUR 1.4 – 1.7 bln in 2011;
  - Consolidated deficit will be lower (4% of GDP in 2010 and 3% of GDP in 2011);
  - The current account deficit will be 8-9% of GDP at most compared to 13.4% in 2006.

... current consumption remains the key challenge!

- The increase in public sector wages and pensions should be an economic rather than political issue (“You get as much as you pay for!”);
- The issue in Serbia is low domestic demand, but the solution lies not in increasing current consumption - which we cannot afford, but in higher public investment - which we can afford!!!;
- Cuts in current consumption are painful and unpopular, but we have all (?) long been aware that they are necessary!

What can we learn from our own economic history?

- Going back to the earlier model of growth based on excessive domestic consumption is unacceptable as it would lead us into the “Greek” scenario trap;
- The crisis has sobered us up and we should avoid the traps of the past by implementing sound economic policy;
- **It remains to be seen if the change in economic policy is the expression of necessity (IMF supported program) or a change in the model of behaviour (Serbia has become aware that it has to change)!!!**