



Current monetary and macroeconomic developments – September 2010

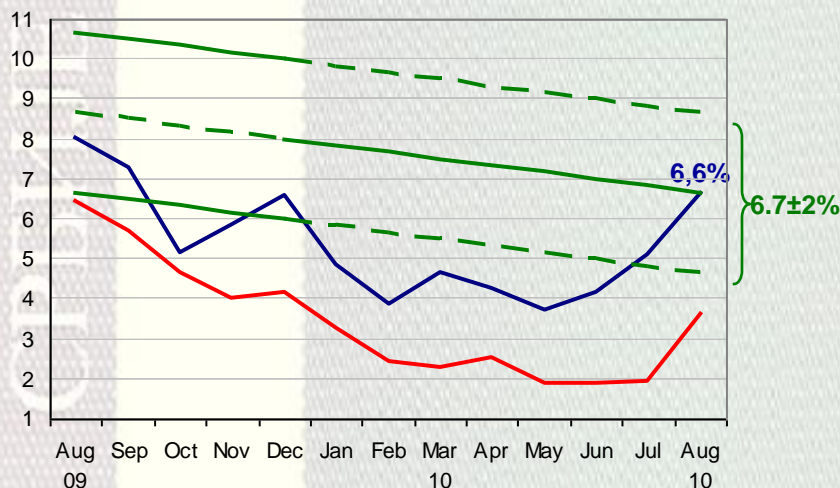
Dr Dejan Šoškić – Governor, National Bank of Serbia

Belgrade, 15 September 2010

August inflation was higher than anticipated on the back of a hefty rise in food prices

Price movements

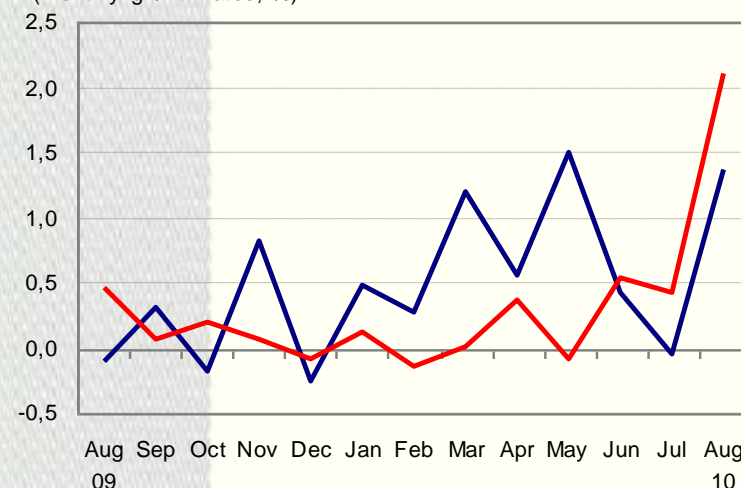
(y-o-y growth rates, %)



— Headline inflation
— Core inflation

Price movements

(monthly growth rates, %)

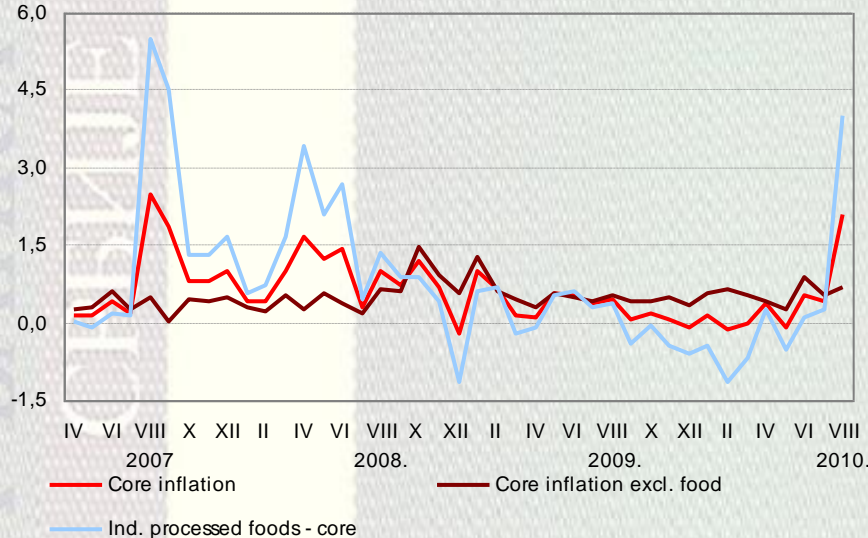


- In August, consumer prices increased by 1.4% as a result of:
 - Hefty rise in processed food prices included in core inflation (with an estimated effect of 1.1 pp); and
 - Smaller than expected seasonal decline in agricultural product prices (with an estimated effect of 0.5 pp).
- In August 2010, year-on-year inflation measured 6.6%.

High agricultural product prices were the key trigger of growth in prices of industrial processed foods

Core inflation movements

(monthly growth rates, %)

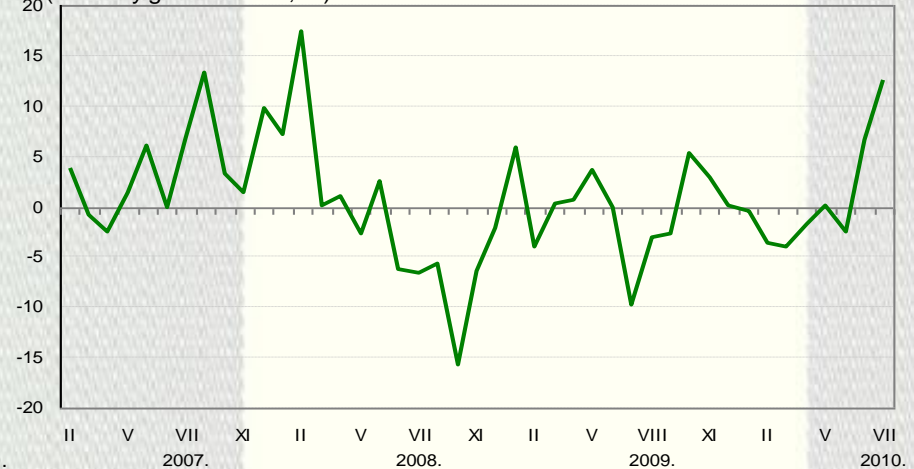


Source: RSO, NBS calculation.

- Adverse weather conditions and high global prices of agricultural products influence inflation:
 - Directly, via high year-on-year growth in retail prices of agricultural products; and
 - Via cost-push effect, as the rise in input prices (wheat, maize and sunflower) prods an increase in processed food prices included in core inflation. In August 2010, the highest price hike was recorded for fresh meat, milk and dairy products, oil and bread.

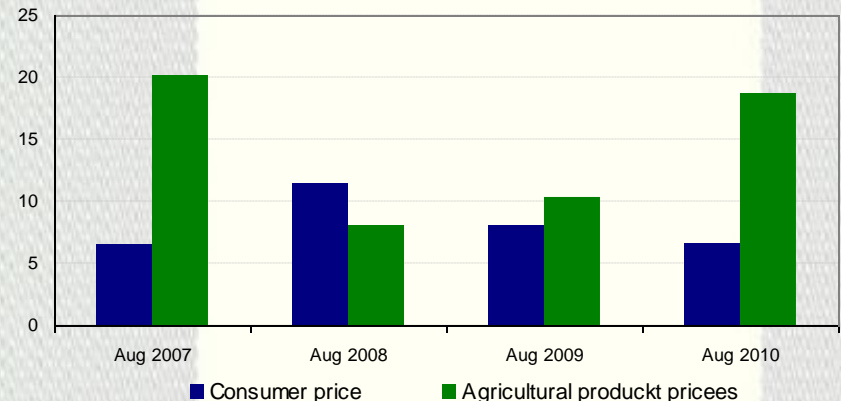
Movements in global grain prices

(monthly growth rates, %)



Growth in headline and agricultural product prices

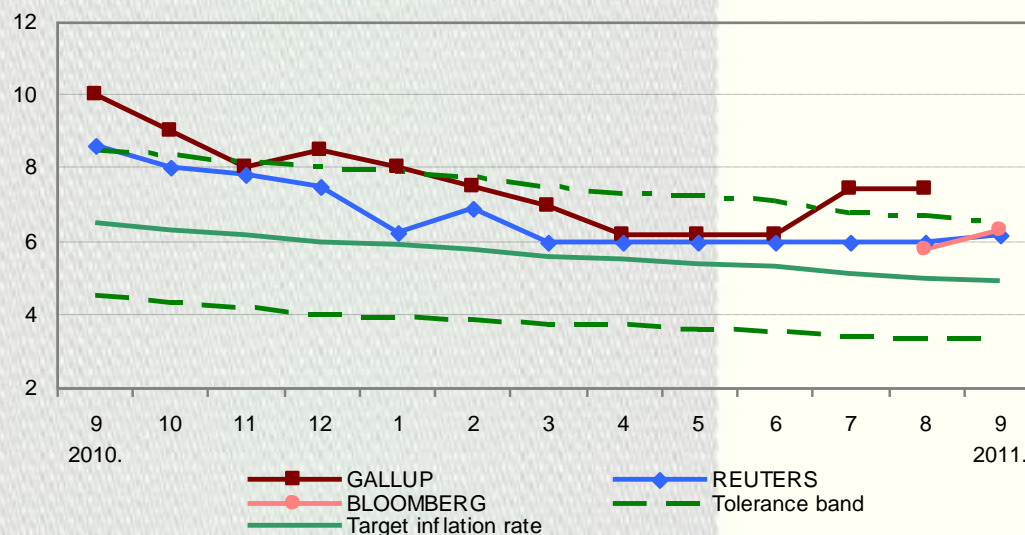
(year-on-year growth rates, %)



Inflation expectations are on the rise

Expected and target inflation rate in the next 12 months - financial sector

(year-on-year growth rates, %)



Results of inflation expectations surveys:

Gallup (August 2010):

- Inflation expectations of the financial sector remained unchanged from July (at 7.4%), while expectations of other sectors increased.

Reuters (September 2010):

- Inflation expectations of the financial sector over the next year edged up from 6.0 to 6.2%.

Bloomberg (September 2010):

- Rise in inflation expectations from 5.8 to 6.3%.

Nature of the agricultural shock: how should the NBS respond?

- In essence, an agricultural shock is a supply-side shock with a cost-push effect.
- Monetary policy response is not aimed at pre-empting a rise in food prices but at preventing a second-round (pass-through) effect.
 - Monetary policy tightening aims to prevent a spill over of food prices to inflation expectations and other prices in order to achieve the medium-term inflation targets.
- Although, as a rule, the agricultural shock has a one-off effect (high monthly inflation rates over the short term), it will be reflected in the year-on-year inflation rate over a one-year horizon.
- In the second half of 2011, even if agricultural yields are only average, we can expect to see weaker inflationary pressures due to a higher base for comparison.

Specific circumstances surrounding the agricultural shock

2007/8 period

- substantial rise in oil prices,
- relatively stable inflation expectations,
- dinar appreciation during 2007,
- rising aggregate demand...

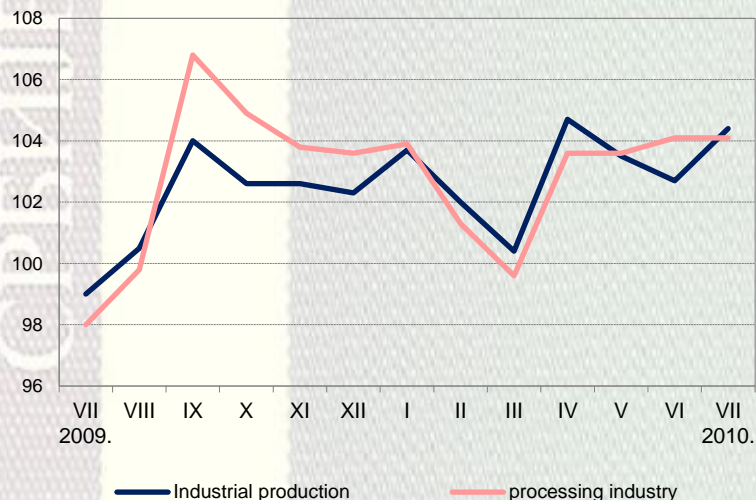
2010 period

- stagnating oil prices,
- rising inflation expectations,
- pronounced depreciation gap,
- low aggregate demand...

A gradual recovery in industrial production...

Movements in industrial production

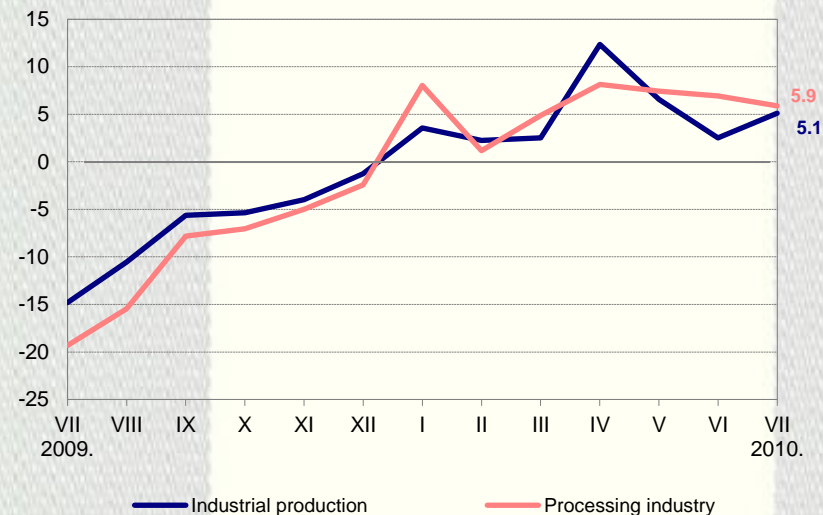
(seasonally adjusted data, 2008=100)



Source: RSO, NBS calculation.

Movements in industrial production

(y-o-y growth, in%)



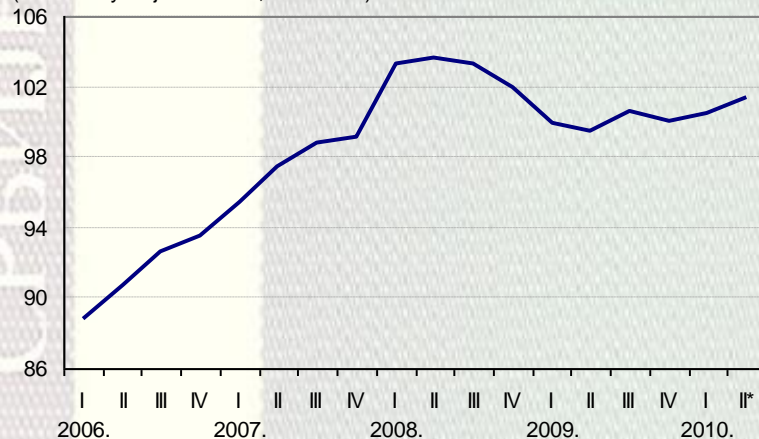
Source: RSO

- In July, seasonally-adjusted growth in industrial production reached 1.7%, but the processing industry remained stagnant. As year-on-year data show, total industrial production and processing industry grew by 5.1% and 5.9%, respectively.
- This year, total industrial production was 4.8% higher than in the comparable period a year earlier.
- In July, retail trade picked up for the first time since end-2008 to record year-on-year growth of 2.8%; seasonally-adjusted growth in retail trade came to as much as 4.4%.

...and expected economic recovery in 2010...

Gross domestic product

(seasonally-adjusted data, 2009=100)



Contribution to y-o-y growth GDP

	2007	2008	2009*	2010*
GDP	6,9	5,5	-3,0	1,5
Domestic demand	12,7	7,9	-10,2	0,2
Total final consumption	9,0	5,9	-5,0	-0,8
Investment	3,7	2,1	-5,2	1,0
Net exports	-5,8	-2,4	7,2	1,3

*NBS estimate

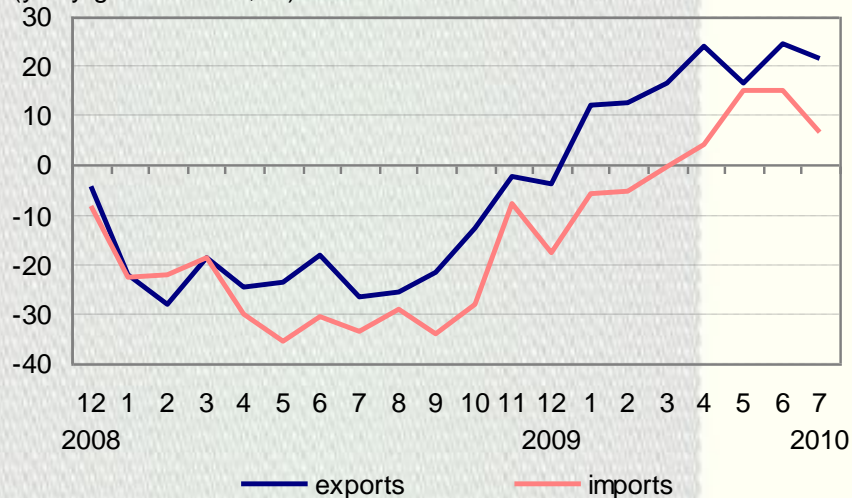
Source: RSO

- In Q2, economic growth is estimated to have reached 1.8% y-o-y and 0.9% in seasonally-adjusted terms.
- GDP is expected to grow by 1.5% in 2010, in response to rising export demand and investments. Household spending will be on a moderate decline.
- The IMF's and our estimate of economic growth coincide (1.5%), while Consensus Forecast projects somewhat higher growth (1.8%).

...are aided by rising external demand, whilst imports are stagnating...

Commodity exchange

(y-o-y growth rates, %)

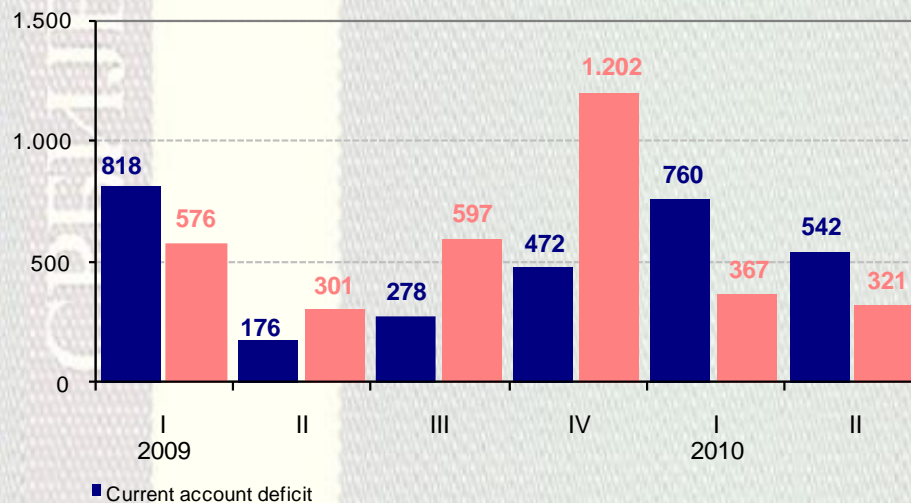


- In Q2 2010, growth in exports outstripped that in imports (22% vs. 11%). This trend continued into July (22% vs. 7%).
- The key boost to imports in July came from the purchase of intermediate goods (28% y-o-y) and equipment (13% y-o-y), while imports of consumer goods suffered a sharp decline (25%).
- Foreign trade picked up due to the current depreciation of the dinar. In view of the imports structure, industrial output is likely to rise.

... partly due to strained access to financing

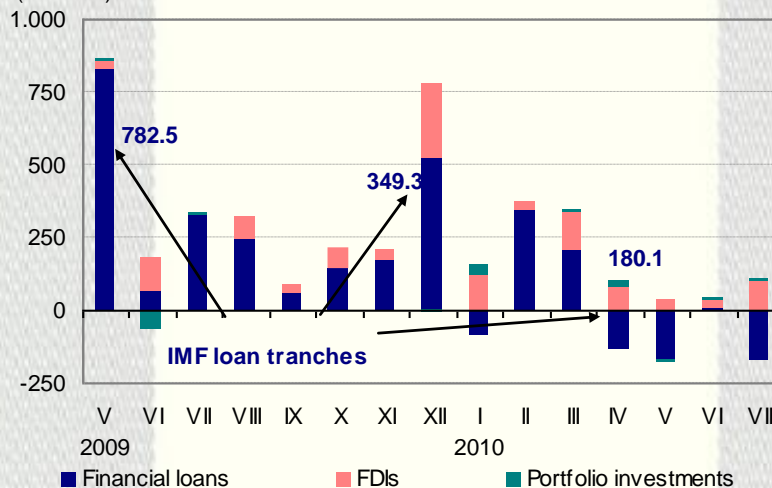
Balance of payments

(quarterly, in EUR mln)



Net capital inflow

(EUR mln)

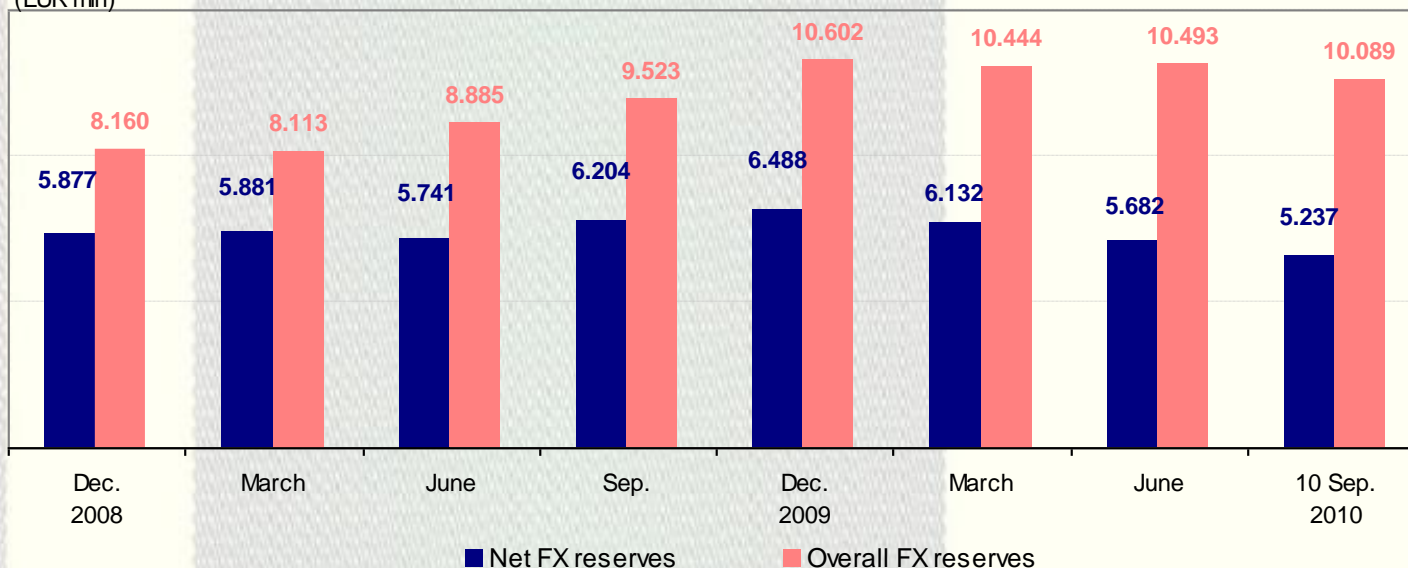


- Current account deficit narrowed in Q2 relative to Q1 (7.2% of GDP). However, due to high risk premium, capital inflow did not suffice to cover current account deficit.
- In Q2, net FDI inflow came at around EUR 140 mln, whereas banks and enterprises repaid around EUR 700 mln net. In July, FDIs totalled EUR 100 mln and banks and enterprises continued to service their debt (around EUR 280 mln).
- In 2010, current account deficit is likely to stand at around EUR 2.7 bln, while FDI inflow will probably reach around EUR 1.1 bln.

FX reserves are at an optimum level

NBS FX reserves

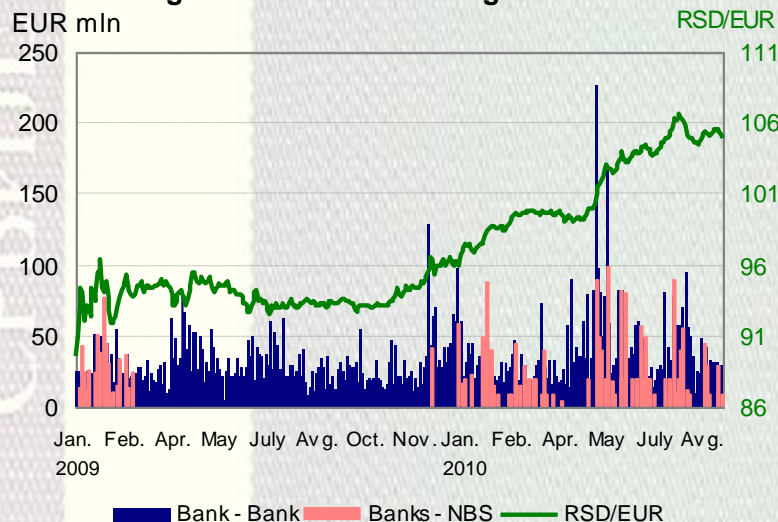
(EUR mln)



- NBS FX reserves (EUR 10.0 bln) are high judging by all optimality criteria.
- In 2010, within the Stand-By Arrangement with the IMF, Serbia has drawn EUR 236 mln (half of the third tranche) in support of its international reserves. Owing to a stable level of FX reserves and the need to minimise the costs of the Arrangement, the tranches are not being drawn in full. Around EUR 1.4 bln has been drawn to date (the Arrangement is worth EUR 2.87 bln).
- In early September 2010, the NBS had at its disposal EUR 5.2 bln that were not collected from reserve requirements or foreign borrowing (net FX reserves). End-September NFA floor agreed with the IMF is EUR 4.6 bln.

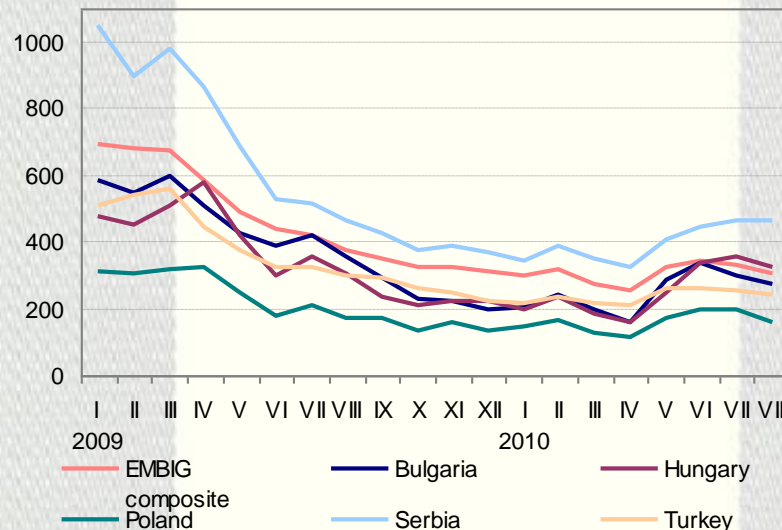
Depreciation pressures are generated by high risk premium

IFEM trading volumes and exchange rate



EMBI by country

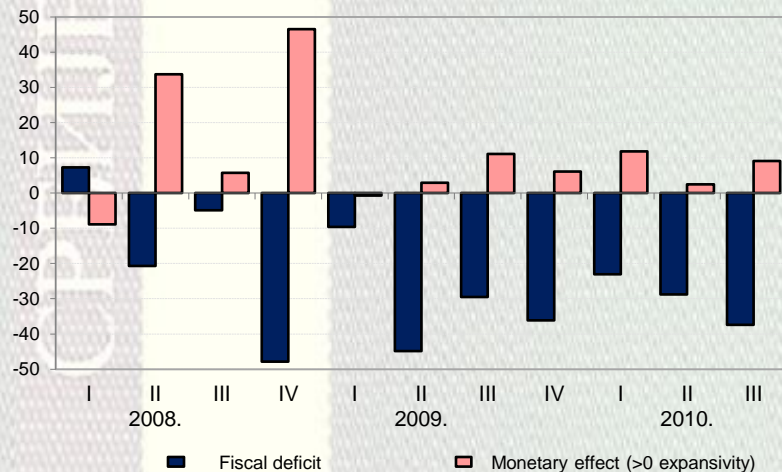
(monthly averages, in basis points)



- Heightened risk premium and depreciation pressures were manifest across the region in May and June due to investors' negative perception of the outcome of the eurozone debt crisis. Since July, other countries have been experiencing a reduction in risk premium, apart from Serbia whose risk premium remains high.
- Since early May, the dinar has lost around 6%. The NBS has sold to banks EUR 1.24 bln net.
- The mismatch between supply and demand for foreign currency is getting less pronounced. The dinar gained 1% in August.

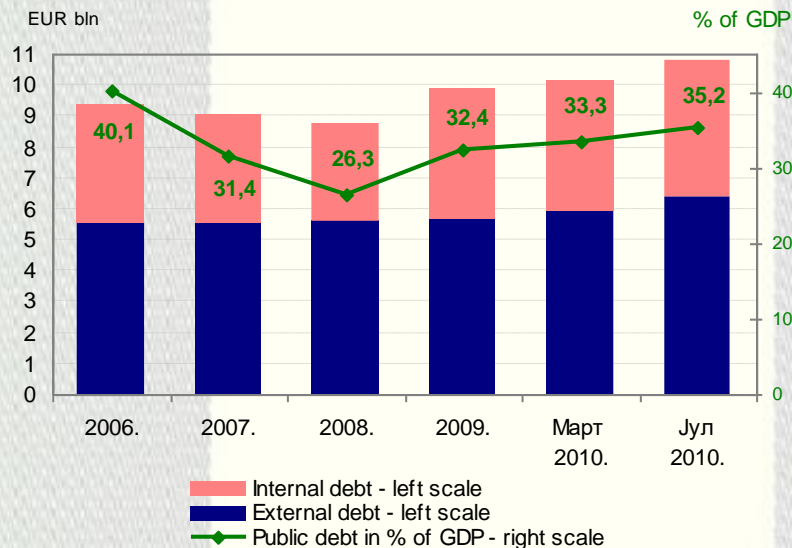
Despite the deficit recorded, fiscal policy is not expansionary in 2010. The degree of expansiveness will, however, increase

Fiscal deficit and monetary effect
(in RSD bn.)



Source: Ministry of finance RS, NBS calculation.

Public debt



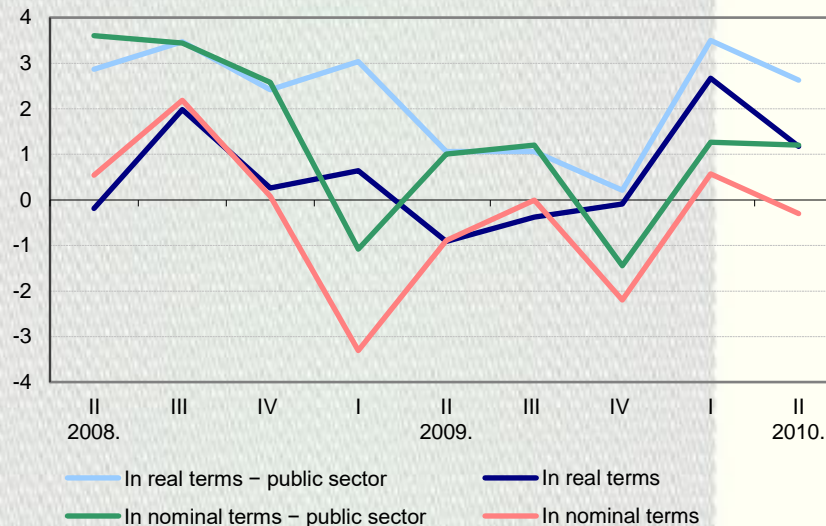
Source: Ministry of Finance.

- As deficit will be financed to a lesser extent via borrowing in the domestic market, fiscal policy will become more expansionary in the coming period.
- Public debt currency structure is improving (albeit slowly). At end-July, dinar-denominated debt equalled 14%.

Earlier than planned lifting of the freeze on public sector wages and pensions

Net wages – total and the public sector

(seasonally-adjusted data, quarterly growth, in %)

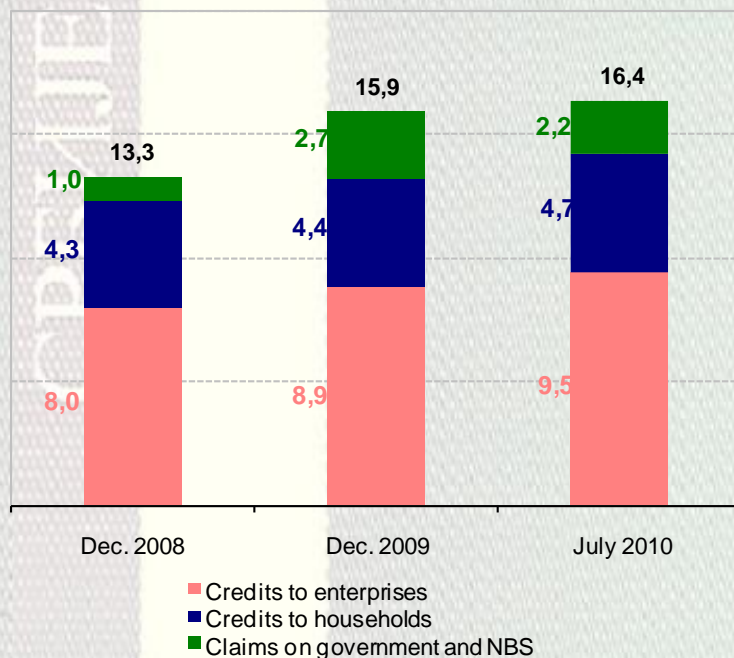


Source: RSO, NBS calculation

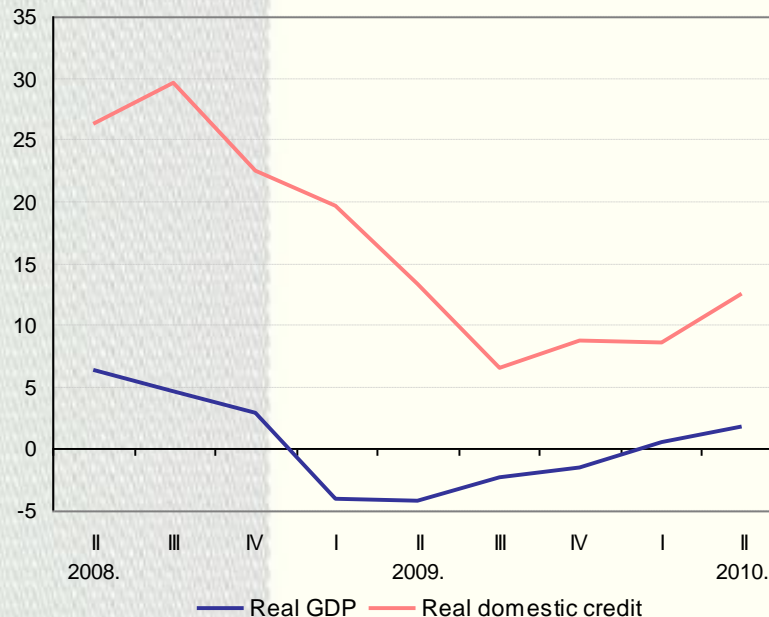
- In seasonally-adjusted terms, growth in total real wages decelerated in Q2, with public sector wages declining. In July, nominal wages recorded monthly growth of 0.6%, while real wages went down by 0.4%.
- In agreement with the IMF, the freeze on public sector wages and pensions will be lifted in January, instead of April 2011.
- This is likely to generate moderate positive effects on economic and foreign trade activity, but not on inflation (0.3-0.4 pp).

Domestic credit portfolio increased in 2010, while the volume of cross-border credits declined

Commercial bank credit portfolio
(EUR bln)



Real domestic credit and real GDP
(y-o-y growth rates, %)



- Growth in bank lending activity continued in 2010 – in July, it measured 11.7% y-o-y in real terms.
- The share of foreign currency clause-indexed loans contracted by 2 pp in 2010 (to 73% in July).
- Corporate foreign debt (EUR 10.3 bln in July) fell by around EUR 320 mln during the year.

Why dinarisation?

- ❖ RSD is the only legal tender we have
- ❖ Foreign exchange risk in the system
- ❖ Smaller scope for monetary policy and weaker monetary policy effects

Dinarisation strategy

- **Strategic action:**

- To provide macroeconomic stability (sustainable economic growth, low and stable inflation, stable exchange rate);
- To develop dinar money and capital markets;
- To develop FX hedging instruments.

- **Steps taken so far:**

- NBS: holding swap auctions; promoting dinar loans by abolishing mandatory collateral deposit for household loans and by raising the borrowing limit for citizens from 30% to 40% of their monthly income provided minimum 80% of debt is dinar-denominated; lowering the dinar reserve requirement ratio from 10% to 5%;
- Government: contributing to the formation of the dinar yield curve by issuing t-bills of longer maturities; since May 2010, subsidising only dinar liquidity and consumer loans; differentiated tax treatment of interest income (10% tax on FX savings, 0% on dinar savings).

- **Steps to be taken:**

- To promote the use of hedging instruments;
- To encourage development of the capital market by including international financial institutions in dinar securities' issuing and trading;
- To develop secondary capital market;
- To continue consumer education and protection efforts;
- To introduce other dinar securities: municipal, corporate.

Y-o-y inflation has stepped up in Q3 2010

Short-term inflation projection
(y-o-y growth rates, %)



- In September too, consumer price movements will be driven primarily by the growth in processed food prices.
- September inflation will amount to around 7.2% y-o-y, exceeding the midpoint of the monthly target ($6.5 \pm 2\%$).
- The key risk to inflation outlook is associated with the unusually pronounced volatility of food prices.

At its meeting held on 7 September, the NBS Executive Board decided to raise the key policy rate to 9%

- Price growth driven by the food price hike is not in itself a reason for raising the key policy rate, but its pass-through to inflation expectations is.
- Depreciation pressures, resulting from the high risk premium, feed through into higher import prices.
- Due to low aggregate demand, depreciation has so far weighed down more on importers' profit margins and less on prices, but now the scope for further lowering of profit margins is significantly reduced.
- As the economy recovers, the disinflationary effects of low aggregate demand grow weaker. This process will also be aided by the planned unfreezing of public sector wages and pensions.