NATIONAL BANK OF SERBIA

Speech at the presentation of the *Inflation Report* – February 2022

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

We shall now present to you in more detail our new macroeconomic projections of GDP and inflation, and the expected movement of the underlying key factors from the domestic and international environment.

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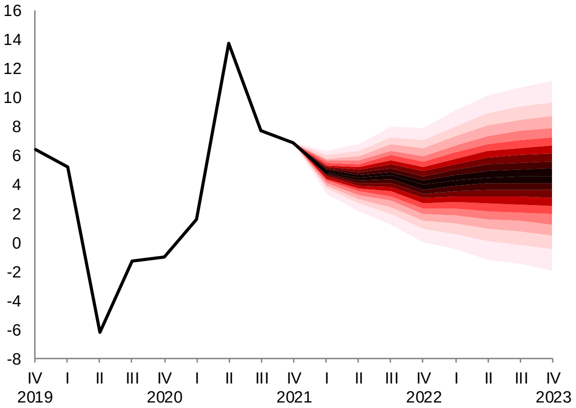
As Governor Jorgovanka Tabaković stated in her introductory address, GDP maintained a relatively strong growth dynamics in Q4 2021 and, according to estimates of the Serbian Statistical Office, posted growth of 6.9% y-o-y. This exceeded our expectations and resulted in real GDP growth at the annual level measuring 7.5%. On the production side, such growth was mostly aided by the service sectors, which suffered the most in the first stage of the pandemic, and then the construction sector, manufacturing industry – despite the persisting challenges in terms of halts in global supply chains – and mining. The only negative contribution to growth came from agricultural production, which recorded a fall of 5% due to drought.

According to NBS estimates, quarterly s-a growth in Q4 equalled 1.6%, whereby at the end of the year, GDP was more than 5% above the pre-crisis level, i.e. the level from Q1 2020. Also, it is important to note that faster than expected economic growth in Q4 2021 on account of the carry-over effect, which is estimated at around 2%, is what makes our GDP growth forecast for this year more certain. With this in mind, although leading financial institutions – the IMF and the World Bank – assess global economic growth outlook for this year as somewhat less favourable than three months ago, we still kept Serbia's growth projection within the 4–5% range, which is the same as our medium-term expectations.

According to our estimates, thanks to a further increase in employment and wages, and favourable lending conditions, we expect the biggest contribution to GDP growth to come from **private consumption**, which is estimated to rise more slowly than total GDP in the coming period, thereby making economic growth sustainable in the medium run.

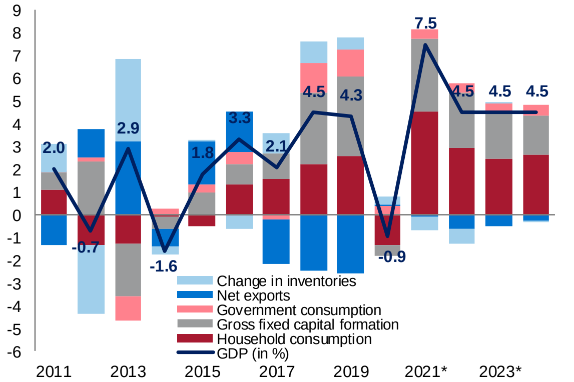
We also expect **fixed investments** this year, as well as in the medium term, to maintain a relatively strong contribution to growth, which will be facilitated by the realisation of announced infrastructure projects in road, railway and utility infrastructure. The key private investment growth factor are still own sources, which were preserved despite the rise in production costs on account of the increase in the prices of energy and raw materials. Of particular importance for preserving own sources of financing was the fact that during the outbreak of the pandemic, as well as afterwards, production capacities and jobs were preserved owing to timely and comprehensive support of monetary and fiscal policy measures. Growth in private investments is facilitated by the preserved macroeconomic stability and favourable investment environment, reflected in a high FDI inflow. Year after year, FDI inflow is exceeding our projections, and even more importantly, these investments are diversified across projects and mostly channelled to tradable sectors. All of the above should result in the share of fixed investments in GDP exceeding the desirable level of 25% this year and continuing to increase.

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



Source: NBS.

Chart 2 **Contributions to real GDP growth, expenditure side**
(in pp)



Sources: SORS and NBS.
* NBS estimate.

Investments from previous years boosted our export supply, which, aided by the normalisation of global economic flows and recovery in external demand, contributes to high export growth rates. In conditions of stepped-up equipment import for the purpose of realising the above investment projects, this and the following two years we expect a mild negative contribution of **net exports**. Nevertheless, we expect the share of the current account deficit in GDP to be relatively stable and remain below 5% over the medium term, as well as remain fully covered by the net FDI inflow.

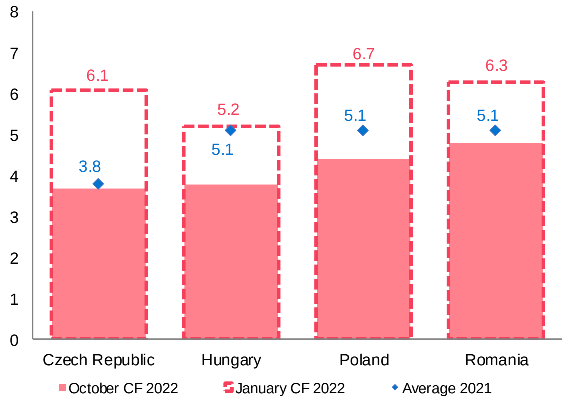
Overall, risks to the GDP projection are judged to be symmetric. As in previous projections, risks from factors emanating from the international environment are still slightly more skewed to the downside, while those on account of factors from the domestic environment are slightly tilted to the upside.

In terms of factors from the international environment, the key downside risk to our manufacturing and exports includes **longer than expected halts in global supply chains and the continuation of the energy crisis**. Consistent with the estimates of relevant international financial institutions, we assumed that bottlenecks in most production sectors will be gradually eliminated during the year, and that the natural gas price will begin to decline as of spring, though problems associated with the gas price globally might persist longer than expected. However, owing to the agreements signed with Russia, which will remain in force until mid-2022, i.e. during the period with the highest risks from the hike in the global price of gas, Serbia will pay most of its gas at the price unchanged from last year, hence we do not expect any major disruptions in the functioning of the local economy on this account. The price of electricity for local corporates has indeed increased, but we must bear in mind the fact that many companies signed more favourable long-term contracts with the Electric Power Industry of Serbia, therefore they did not incur higher costs for electricity. Another thing that needs to be highlighted is that the price of electricity for corporates has been limited by government measures to EUR 75 MW/h for the next six months, when pressures towards its growth in the global market are likely to be the most pronounced. In addition, it should be noted that in case of the higher prices of gas, the external competitiveness of domestic companies would most likely be preserved because rival companies in the EU are faced with a much bigger increase in gas and electricity prices.

As for domestic factors, we single out a possibly **higher than expected rise in fixed investments**, which are the healthiest source of GDP growth as they also boost potential output. Above all, we believe that the FDI inflow could exceed our estimates, which are traditionally conservative. In addition, we believe that government fixed revenue defined by the Fiscal Strategy, which we used as a projection assumption, is projected conservatively and that its better realisation would open up additional room, which would be used mainly for growth in government capital expenditure.

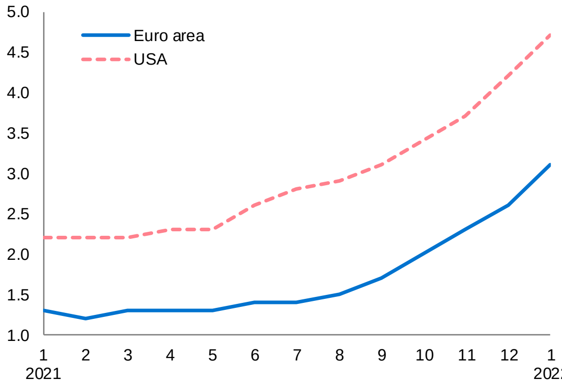
I will now briefly present our new **inflation projection**. Over the past days and months almost all central banks revised up their inflation projections as cost-push pressures turned out to be more inflationary and durable than initially expected. Central banks concur in their estimate that elevated cost-push pressures on account of the prices of energy, food and industrial raw materials, including disturbances in supply chains, will generate inflationary pressures in the short run, but to a lesser extent than so far as most of these costs have already translated onto consumer prices. In the second half of the year, a significant slowdown in inflation is expected. Our expectations are consistent with this.

Chart 3 **Revision of inflation forecasts for 2022**
(in %)



Source: Consensus Forecasts

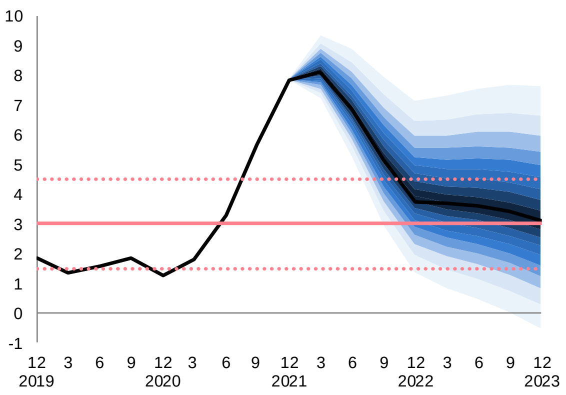
Chart 4 **Revisions of inflation forecasts for 2022 in the past year**
(y-o-y growth, in %)



Source: Consensus Forecasts.

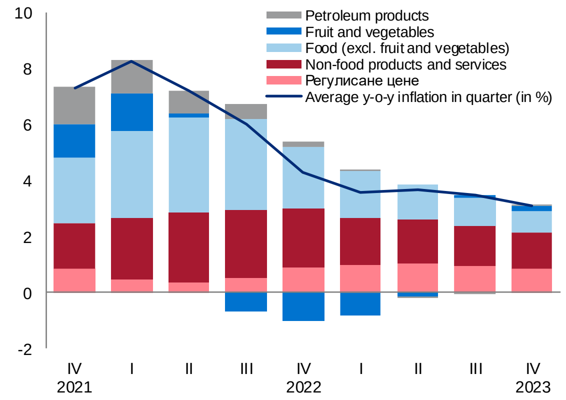
Under our new projection, headline inflation in Q1 this year will be at a similar or slightly higher level than in December, when it measured 7.9% y-o-y. We expect inflation to reach its peak most probably in February, whereafter it should be declining until the end of the projection horizon. The inflation's slowdown will be encouraged primarily by the drop-out of last year's hikes in petroleum product prices from y-o-y inflation, while in the middle of the year, the onset of the new agricultural season should result in a reduction in the currently high prices of fruit, vegetables and raw materials in processed food production. Moreover, in line with estimates of leading international financial institutions, we expect the weakening of the effects of higher cost-push pressures from the international environment on various grounds – global primary commodity prices, halts in global supply chains, prices of international transport, producer and import prices, although all these factors in the new projection generate more inflationary pressures compared to the previous projection. Under our new projection, **y-o-y inflation will measure from 3.5% to 4% by late 2022, whereafter it will continue to slow and move around the midpoint.**

Chart 5 **Inflation projection**
(y-o-y rates, in %)



Source: NBS.

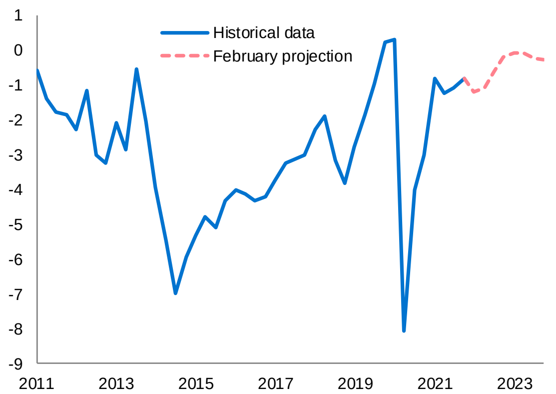
Chart 6 **Contributions to y-o-y inflation by component**
(average y-o-y rate, in pp)



Source: NBS.

Since GDP growth in 2021 exceeded our expectations, the question of the impact of domestic demand on inflation can be raised. According to our estimate, in the inflation projection horizon, i.e. next two years, disinflationary pressures on account of aggregate demand will gradually wane. However, we must emphasize that in addition to economic growth, our production capacities are expanding as well, which means that demand growth is accompanied with supply growth, i.e. neither in the projection horizon nor in the medium run will there be a risk of an overheating economy. Along with preserved relative stability of the exchange rate, this contributes to lower core inflation than headline inflation and its more stable movement.

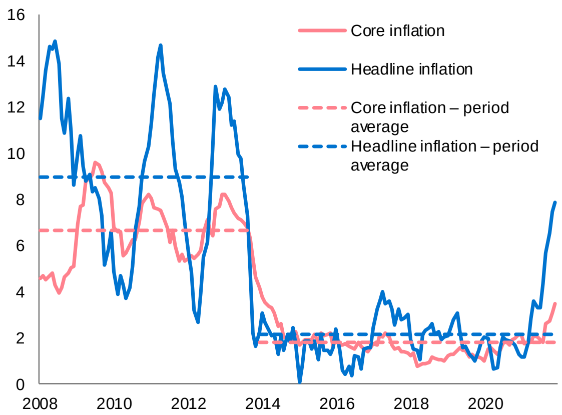
Chart 7 **Output gap projection***
(in % of potential output)



Sources. SORS and NBS.

* Output gap is estimated on the basis of NAVA.

Chart 8 **Headline and core inflation**
(y-o-y rates, in %)



Sources: SORS and NBS calculation.

Uncertainty concerning the achievement of the inflation projection is still mainly associated with the international environment and relates chiefly to the **duration of halts in global supply chains and the energy crisis, movement in the global prices of energy and primary agricultural commodities, and the normalisation of the monetary policies of leading central banks**. Currently one of the greatest global uncertainties concerns the movement of crude oil prices, which stepped up since the start of the year. However, market expectations based on futures prices still indicate that these prices should decline this and in the next two years.

The risks to the inflation projection are partly associated with the domestic environment as well – primarily the **next agricultural season, the dynamics of domestic demand and administered price movements**. When it comes to domestic food prices, their further movement will also largely depend on the next agricultural season in Serbia, which, for projection purposes, is set at the level of a five-year average. In case of an agricultural season that would be above or below the average, by late this year inflation could get close to the lower or higher bound of the NBS target tolerance band, which equals 3±1.5%.

Ladies and gentlemen, dear colleagues,

At the end of my today's address, I would like to highlight that the February *Inflation Report* contains five text boxes on current topics:

1. In the first text box, we compared the contribution of rising prices of food and oil to inflation in 2021 with the previous episodes of their high rise in the global market;
2. The second text box analyses the pandemic's impact on the balance of savings and investments;
3. The third text box elaborates on how global production and supply halts reflected on the performances of manufacturing and its export in 2021;
4. The fourth text box is devoted to the macroeconomic effects of the global energy crisis on Serbia;
5. In the fifth text box, we showed how different types of price shocks reflect on y-o-y inflation, and we illustratively explained why we expect inflation to be on a downward trajectory this year.

We believe that these text boxes, and the *Report*, which is before you, will give you additional explanations of the impact of global and domestic movements on inflation and the country's economic growth.