NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report – May 2019

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Economic Research and Statistics Department

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

We shall now present to you the current and expected economic developments in the domestic and international environment, which have motivated monetary policy decisions of the NBS.

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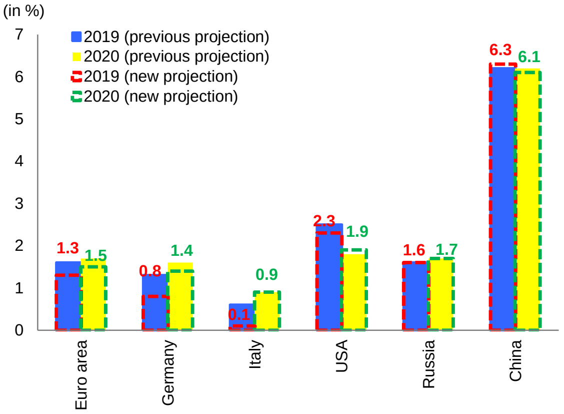
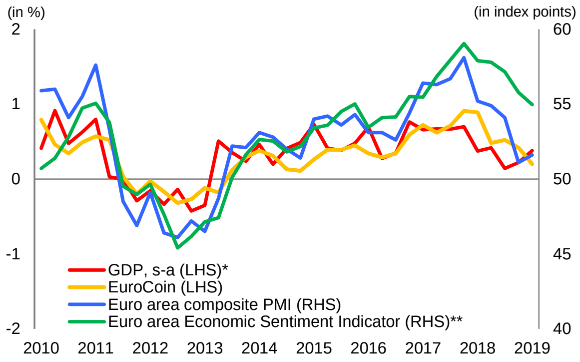
At the start, I will give a brief overview of developments in the international environment, which is still beset with considerable uncertainty, and the impact of such environment on emerging economies, Serbia included. Since our presentation in February, the global growth outlook has deteriorated again, notably in the short run. However, the recent announcements of leading central banks that the normalisation of their monetary policies will be slower, the easing of trade tensions and the latest macroeconomic data suggest that global trends in the coming period could be somewhat more favourable than expected. The growth forecast of the euro area, our key trade partner, was revised down for this year, but Q1 growth surprised on the upside, speeding up to 0.4%, from 0.2% and 0.1% in the previous two quarters. Though slightly revised up, the economic growth of countries of our region, which are also our important trade partners, is expected to remain relatively high, led by elevated domestic demand.

Chart 1 **IMF's revised forecast of real GDP growth for 2019 and 2020**
(in %)



Source: IMF WEO (April 2019) and IMF WEO Update (January 2019).

Chart 2 **Movements in euro area GDP and economic activity indicators**
(quarterly rates)



Sources: Eurostat, Markit Group, Banca d'Italia and European Commission.
* Eurostat preliminary estimate for Q1 2019.
** ESI is standardised relative to PMI.

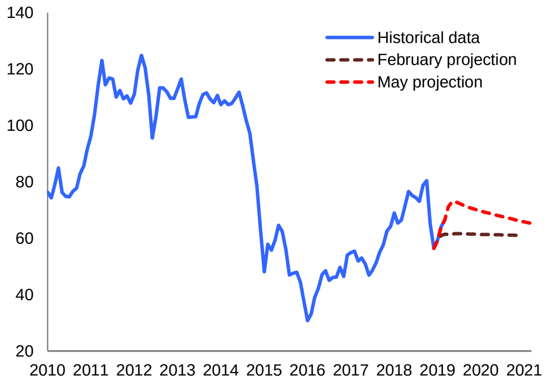
The inflation outlook has also been revised down in the majority of countries, primarily due to the expected global growth slowdown. A risk associated with global oil prices is present as well. Our projection assumes that euro area inflation will move in accordance with the ECB's projection – below the inflation target in the next two years as well. In light of this, the growth in our import prices is likely to remain relatively low.

In the context of expected lower global growth and a slower rise in inflation, the Fed announced it would be "patient" on any future interest-rate moves, while the ECB announced a new long-term financing programme, to be implemented from September 2019 to March 2021, so as to ensure that lending conditions remain favourable. This should positively affect conditions in the international financial market and capital flows towards emerging economies, as well as the stability of their FX markets. It, however, remains uncertain to what extent the normalisation of monetary policies of leading central banks will be slower and different from market expectations, which mandates caution, since this could trigger sudden changes in global capital flows.

Uncertainty as to future movements in the international environment is also associated with global primary commodity prices. Also uncertain is the movement in global oil prices, which since the start of the year went up by around 30% (to around USD 70 per barrel), reflecting the cap on production of leading world exporters and geopolitical tensions. However, market participants do not expect any significant oil price hikes in the coming period. Moreover, according to futures, oil prices are likely to stay at the current level by late this year, and to be somewhat lower in the next two years. As suggested by futures, no significant changes in global primary agricultural commodity prices are expected either.

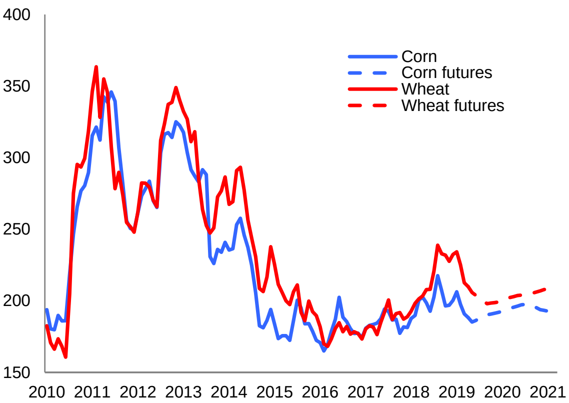
Chart 3 **Assumption for Brent oil prices**

(USD/barrel)



Source: Bloomberg.

Chart 4 **Primary agricultural commodity prices**
(USD/t)



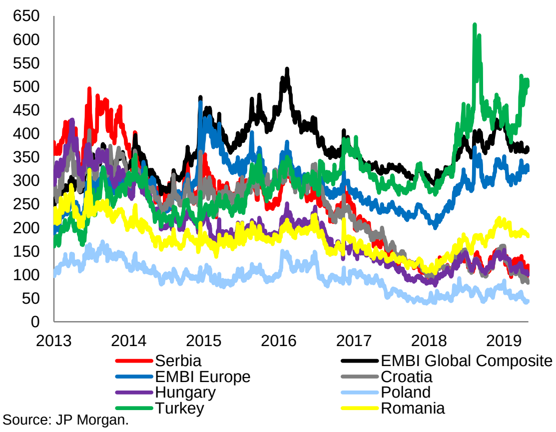
Sources: Euronext and NBS calculation.

In contrast to uncertainties in the international environment, the domestic macroeconomic conditions of monetary policy conduct remain favourable. Q1 saw a fiscal surplus of RSD 11.2 bn, against the backdrop of much higher government capital expenditure and increased outlays for wages and pensions, owing to economic growth and rising employment and wages. At the same time, the share of public debt in GDP fell to 50.9% at end-March. Its downward trajectory is expected in the coming period as well.

The share of external debt in GDP is also declining, which, along with the high FDI inflow, contributes to the sustainability of the country's external position. FDI still largely covers the current account deficit, which has been, since the start of the year, under the impact of rising investment and dented external demand, as well as 100% tariffs on products delivered to Kosovo and Metohija. Goods imports rose somewhat faster than exports owing to the continuation of the investment cycle. Despite the slowdown in external demand, exports growth remained relatively high thanks to new production capacities and the exports of agricultural inventories from last season. The current account deficit is estimated at around 5.0% of GDP this year. It is expected to narrow further in the medium run, on the back of earlier investment in tradable sectors. The net FDI inflow is assessed to be stable in the coming years, at the level of around 5% of GDP, and will be, as so far, more than sufficient to cover the current account deficit.

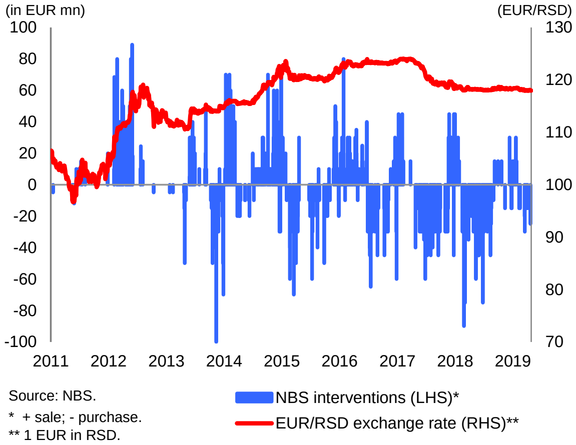
The improved internal and external position of the country, along with sustainable economic growth, is the basis for further improvements of our country's outlook. This is confirmed by the low risk premium and a more favourable credit rating of the country, which strengthens Serbia's resilience. Following moderate depreciation pressures in January, appreciation pressures – which marked the past two years as well – have re-emerged as of February. To mitigate excessive short-term volatility of the dinar against the euro, since the start of the year the NBS has intervened by buying EUR 110 mn net, thus pushing up the country's FX reserves.

Chart 5 **Risk premium indicator – EMBI by country**
(daily, in basis points)



Source: JP Morgan.

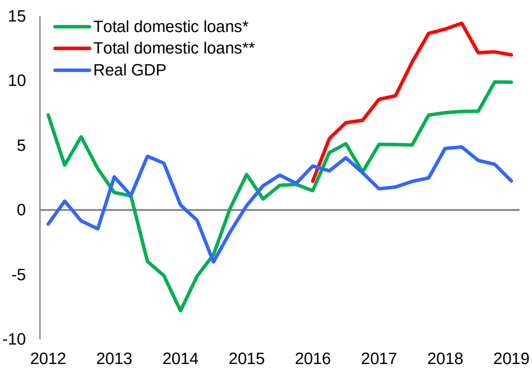
Chart 6 **Movements in EUR/RSD exchange rate and NBS FX interventions**



Source: NBS.
* + sale; - purchase.
** 1 EUR in RSD.

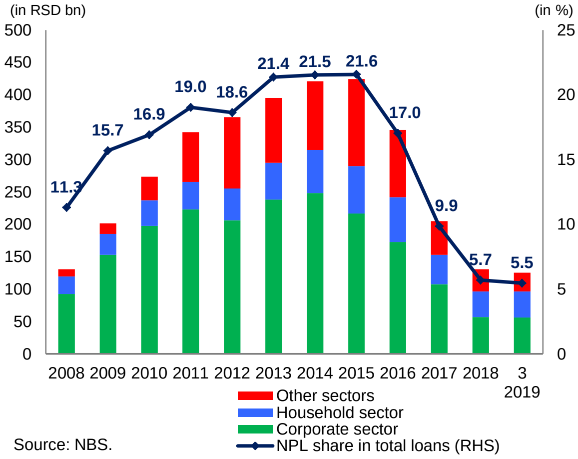
The NBS's key policy rate is at its lowest level in the inflation targeting regime (3.0%), which reflects positively on the terms of financing of the private sector and government. Interest rates on dinar loans dropped to new lows which, coupled with the rising economic activity, wages and employment, led to a stable growth in lending of 10.1% y-o-y in March (excluding the exchange rate effect). If the effects of NPL write-off and assignment are excluded from the calculation, lending growth is even stronger, measuring 12.2%.

Chart 7.**Lending activity and GDP**
(y-o-y rates, in %)



Sources: NBS and SORS.
* Excluding the exchange rate effect.
** Excluding the effect of NPL write-off and sale since early 2016.

Chart 8 **NPL share in total loans, gross principle**



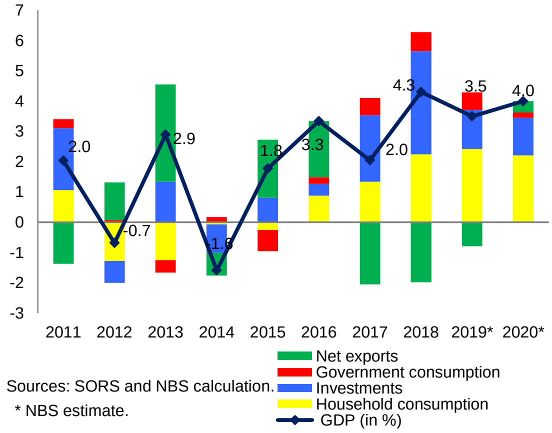
Source: NBS.

* * *

Economic activity continued up for the eighteenth consecutive quarter, with Q1 2019 witnessing growth in all key sectors, except for agriculture due to the high base effect. The greatest contributor to Q1 growth was the rebound in industrial production, which had been affected by the euro area slowdown for most of 2018. Still, the effect of the weaker external demand on industrial production remains visible – together with the base effect in agriculture, it led to the 2.3% y-o-y GDP growth in Q1, as estimated by the Serbian Statistical Office.

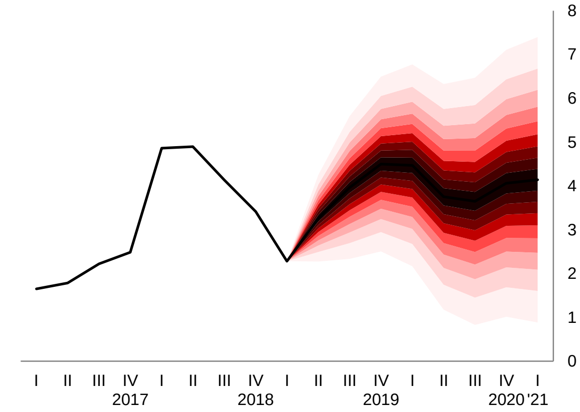
We kept the GDP growth forecast for 2019 at 3.5%, with a slight change in the growth structure. Same as in the previous projection, GDP is expected to be fully led by domestic demand, which is likely to enjoy higher growth thanks to more favourable trends in final consumption and especially investment since the start of the year. On the other hand, due to the slower growth in the euro area, the negative contribution of net exports should be somewhat higher compared to the previous projection. GDP growth is expected to pick up in the medium-term, to around 4%, led by investment, exports and household consumption rising on sustainable grounds.

Chart 9 **Contributions to annual GDP growth**
(in pp)



Sources: SORS and NBS calculation.
* NBS estimate.

Chart 10 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

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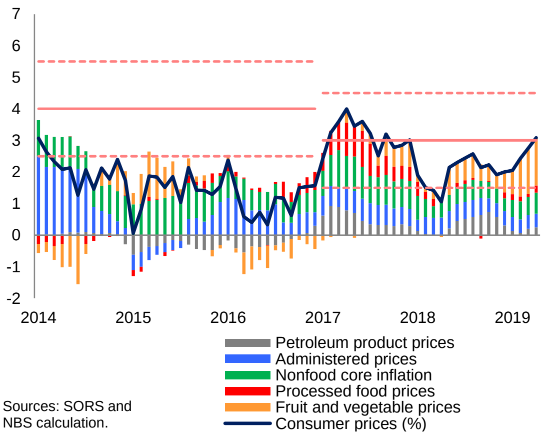
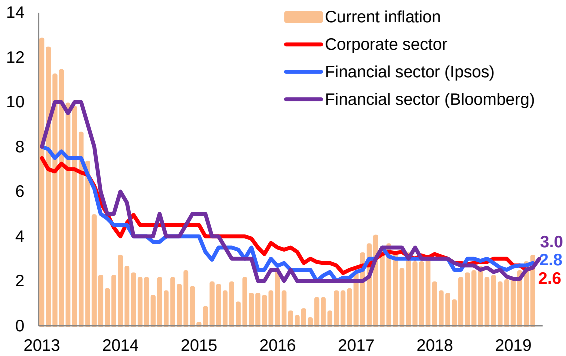
Inflation continued to move within the bounds of the target (3.0±1.5%) and, consistent with our announcements, gradually approached the target midpoint since the start of the year. It should be noted that more than half of the April's inflation of 3.1% y-o-y was triggered by the rise in vegetable prices. On the other hand, core inflation remained low, moving between 1.2 and 1.4% y-o-y since the beginning of the year.

Chart 11 **Contribution of CPI components to y-o-y inflation**
(in pp)



Sources: SORS and NBS calculation.

Chart 12 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, in %)

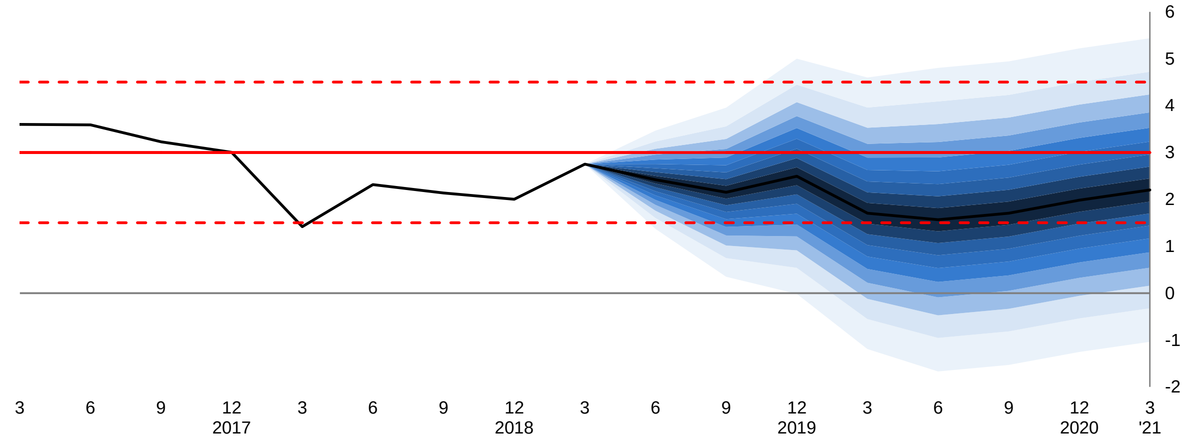


Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.

* Ipsos and Gallup agencies until December 2014, Ninamedia agency since December 2014, and Ipsos agency since January 2018.

In our May central projection too, y-o-y inflation is expected to continue moving within the target band until the end of the projection horizon, most likely in its lower part.

Chart 13 **Inflation projection**
(y-o-y rates, in %)



Source: NBS.

After reaching the target midpoint in April, inflation will turn downward, only to approach the lower bound of the target in the first half of the next year and then to embark on a gradual return toward the target midpoint.

Same as in the previous projection, the inflation factor expected to play the key role throughout the projection period is the growth in aggregate demand. Besides, the disinflationary pressures on account of the past appreciation of the dinar should gradually wane, while administered prices are expected to pick up somewhat faster than in previous years. High base for vegetable prices will also put a downward pressure on inflation in the coming period. Uncertainty surrounding the inflation projection relates primarily to movements in the international commodity and financial markets and, to an extent, administered price growth. Overall, the risks to the inflation projection are judged to be symmetric.

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Ladies and gentlemen, dear colleagues,

In the closing of my today's presentation I would like to draw your attention to the four text boxes of the May *Inflation Report* which cover topical issues:

1. The first text box is dedicated to additional FX swap auctions organised by the National Bank of Serbia.
2. The second text box is an empirical assessment of the synchronisation of economic and credit cycles of Serbia and the euro area.
3. The third text box analyses the dynamics of savings and investment balance over a longer period.
4. The fourth text box analyses movements in the market of agricultural and food products in Serbia, which we will soon summarise for you.

Thank you for your attention!