NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report – November 2018

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Belgrade, 16 November 2018

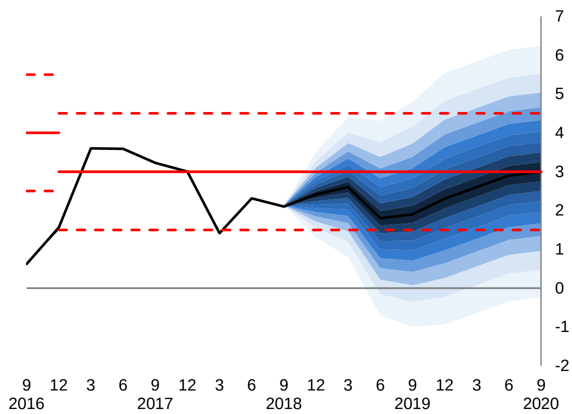
Ladies and gentlemen, esteemed members of the press, dear colleagues,

Let us now give a brief overview of current macroeconomic developments, our new projections of inflation and economic activity, and monetary policy decisions.

It is worth highlighting at the beginning that the NBS **has again revised up its GDP growth forecast for this year, to 4.2% (from 4.0%).** The main reason behind this upward revision is the materialisation of the upside risks that were identified in the August *Inflation Report* – faster growth of construction and agriculture from the start of the year, on the production side, and of investment, on the expenditure side. We kept the growth forecast for 2019 unchanged (at 3.5%), keeping in mind the high base this year. **It is expected that GDP will sustain its growth pace of around 4% in the medium term as well.**

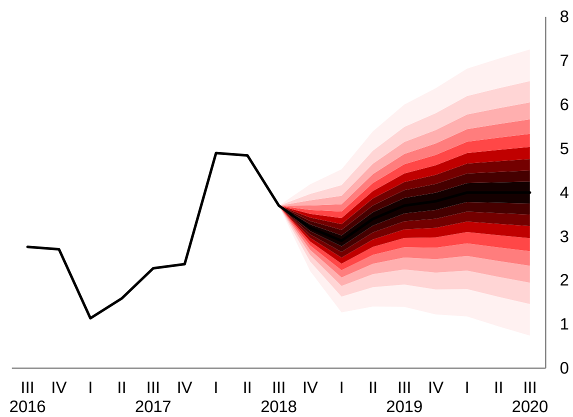
Against the background of the highest economic growth in the last ten years, inflation remained low and stable, consistent with our expectations. In October it measured 2.2% and, same as in previous months, more than half of it originated from two groups of products – petroleum products and fruits and vegetables. Other groups of consumer prices mostly had stable movements. Under our new projection, almost unchanged from the one presented in August, **inflation is expected to remain low and stable, moving in the target tolerance band (3.0±1.5%) in the next two years as well, i.e. until the end of the projection horizon.**

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



Source: NBS.

Chart 2 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

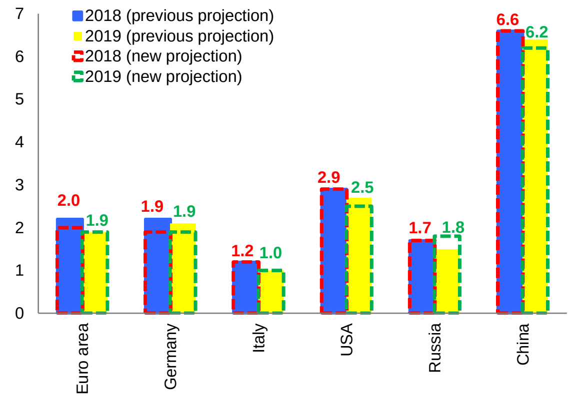
Since our last presentation in August, favourable fiscal trends have continued – the budget has recorded a surplus and public debt is within sustainable boundaries. Full coordination of fiscal and monetary policies, hand in hand with successful fiscal consolidation, provides an impetus to economic growth. The rise in government capital expenditure boosts investment and higher pensions and public sector wages contribute to sustainable consumption growth, while not causing any major inflationary pressures.

Manufacturing exports continued to grow at high rates, while the rise in imports was driven mainly by increased needs of corporates for equipment and intermediate goods, reflecting the current investment cycle. Foreign direct investment remains high, project-diversified and channelled mainly to tradeable sectors. In the first nine months of 2018, **the net foreign direct investment inflow exceeded EUR 1.8 bn, providing more than full coverage of the current account deficit. We expect to see such coverage also in the period ahead.**

* * *

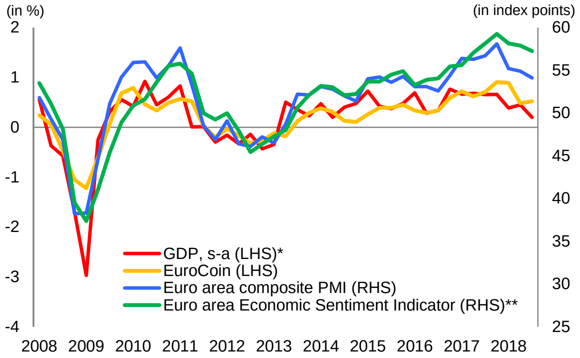
Developments in the international environment grew more complex since we last met in August. Global economic outlook is slightly weaker and the forecast for this and next year was downgraded by almost all relevant institutions, so now it stands at the last year's level of 3.7%. Economic growth of the euro area, our main economic partner, was also revised slightly down, except that its economic activity is expected to remain above potential.

Chart 3 **IMF's revised forecast of real GDP growth for 2018 and 2019**
(in %)



Source: *World Economic Outlook*, IMF (July and October 2018).

Chart 4 **Movements in euro area GDP and economic activity indicators**
(quarterly rates)



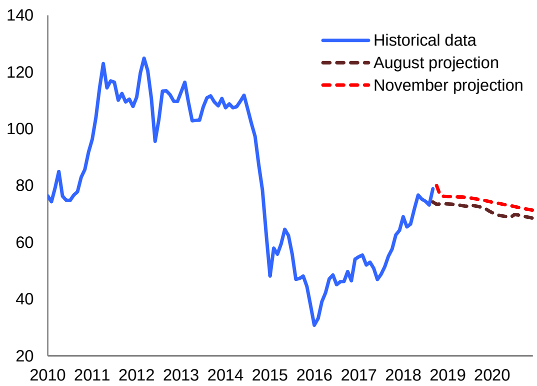
Sources: Eurostat, Markit Group, Banca d'Italia and European Commission.
* Eurostat preliminary estimate for Q3 2018.
** ESI is standardised relative to PMI.

Global inflation is somewhat higher than in the prior period, but still moderate. The European Central Bank did not change its projection of euro area inflation – it still expects inflation to trend slightly below the target, at 1.7% in the next two years.

The rise in oil prices in the global market was the main reason for somewhat higher inflation in the international environment. For more than a year now, the global oil price has been on an upward path. At over 80 dollars per barrel, in Q3 the oil price was on average 46% higher than in the same period last year. Although it decreased thereafter, uncertainty regarding its future movement has intensified, mainly due to geopolitical tensions and supply-side factors. According to oil futures from the beginning of November, which we used in the projection, global oil prices are expected to stabilise at the current levels by the end of this year and to mildly decrease in the next two years.

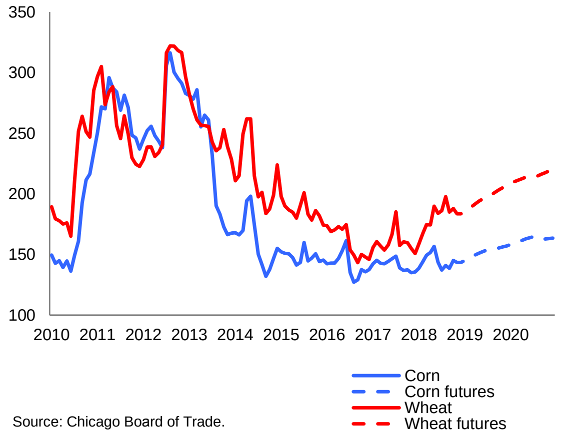
Speaking of other primary commodities in the global market, prices of primary agricultural commodities, which are of relevance for Serbia, declined since our last projection, primarily due to better supply of the majority of grains (except wheat) and protectionist measures. Taking into account futures movement, compared to the previous projection we lowered the assumption for their growth for this year (from 11.3% to 6.0%), and revised up the assumption for the next year (from 6.0% to 9.0%).

Chart 5 **Assumption for Brent oil prices**



Source: Bloomberg.

Chart 6 **Primary agricultural commodity prices**
(USD/t)



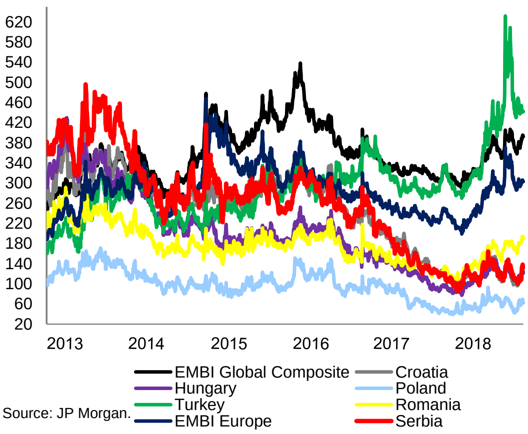
Source: Chicago Board of Trade.

Greater uncertainty surrounding the global growth and inflation outlook also fuels uncertainty in the international financial market regarding the pace of normalisation of monetary policies of leading central banks. The spread of protectionism and tightening of trade tensions could dent investor sentiment and thus, affect global capital flows to emerging economies. However, the European Central Bank will continue to reinvest principal from maturing bonds for an extended period of time after winding up its asset purchase programme by the end of this year, while keeping its key interest rate unchanged at least through the summer of 2019.

Despite mounting uncertainty in the international environment, domestic macroeconomic conditions in which monetary policy is implemented have remained favourable, as evidenced by key macroeconomic indicators. Internal and external imbalances narrowed down significantly, which increased Serbia's resilience in the international environment. This is also suggested by the country risk premium, which is among the lowest in the region and considerably lower than the risk premium of European emerging economies.

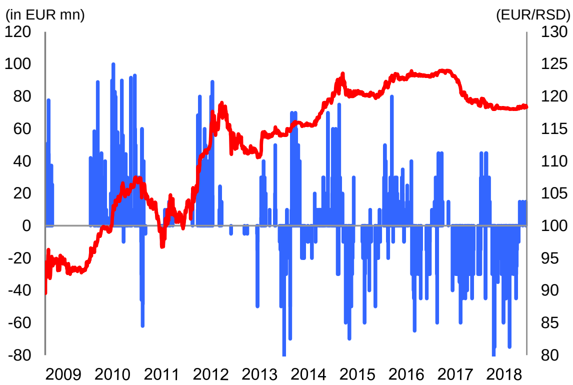
Investors' perception of Serbia is favourable, as also shown by the net capital inflow of EUR 2.2 bn in the first nine months of this year, including mostly foreign direct investment (EUR 1.8 bn net). Same as in the previous three years, foreign direct investment more than fully covered the current account deficit (122.3%) which, coupled with good export results, contributes to relative stability of the dinar exchange rate.

Chart 7 **Risk premium indicator – EMBI by country**
(daily, in basis points)



Source: JP Morgan.

Chart 8 **Movements in EUR/RSD exchange rate and NBS FX interventions**



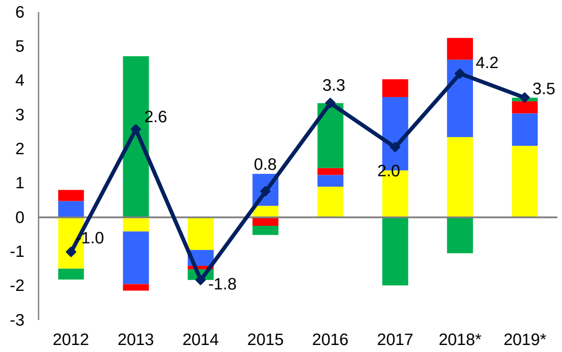
Source: NBS.
* + sale; - purchase.
** 1 EUR in RSD.

NBS interventions (LHS)*
EUR/RSD exchange rate (RHS)**

As appreciation pressures on the dinar prevailed in the major part of 2018, in the year to date the NBS intervened in the FX market by purchasing EUR 1.6 bn net.

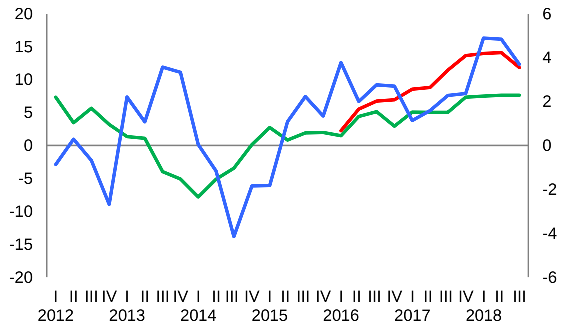
Owing to past monetary policy easing, interest rates on dinar loans moved around the minimum recorded in the past months, which contributed to lending growth. Other favourable factors, particularly economic growth and labour market recovery, higher interbank competition, a lower country risk premium and low euro area rates, propped up lending growth, which in September came at 7.7% y-o-y (excluding the exchange rate effect). Excluding the effect of NPL write-off and assignment, lending growth was even more pronounced (11.9%). The share of NPLs in total loans fell to 6.4% in September, which is the lowest level of this indicator of bank portfolio quality since its monitoring began (2008).

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



Sources: SORS and NBS calculation.
* NBS estimate.

Chart 10 **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.

* * *

Against the background of softening external demand growth, domestic factors pushed up strongly economic growth, to 4.9% y-o-y in the first half of the year, which was above our expectations. A brisk pace of growth extended into Q3 as well (3.7%). The largest contribution continued to come from service sectors and construction, as well as excellent agricultural performance. On the expenditure side, an impetus was provided by investment and household consumption. GDP growth continued into the fourteenth consecutive quarter, and came at 0.3% s-a in Q3.

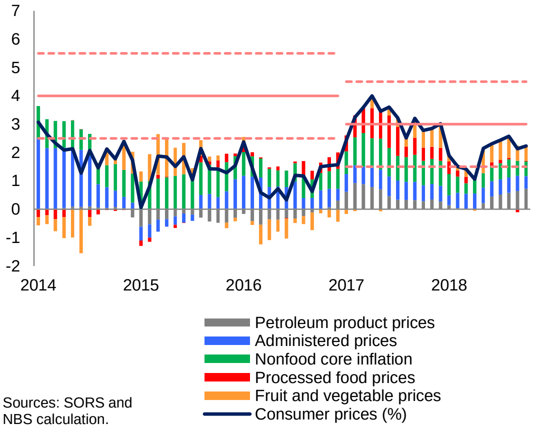
In view of the faster growth in construction and agriculture since the start of the year on the production side, and rising investment on the expenditure side, we raised the GDP growth projection for 2018 to 4.2%. The growth forecast for 2019 was kept unchanged (3.5%) because of the higher base this year. Growth in exports is expected to exceed that in imports, on account of past investment, elevated external demand and high export inventories of agricultural products following an excellent season this year. GDP growth is estimated to continue to be led by domestic demand, i.e. investment and household consumption.

The risks to the GDP projection are assessed to be symmetric, while the risks emanating from the international environment are mildly asymmetric to the downside (due to the potentially faster than expected slowdown in the euro area), while the risks associated with the domestic environment are mildly tilted to the upside (due to the potentially faster than expected growth in construction).

* * *

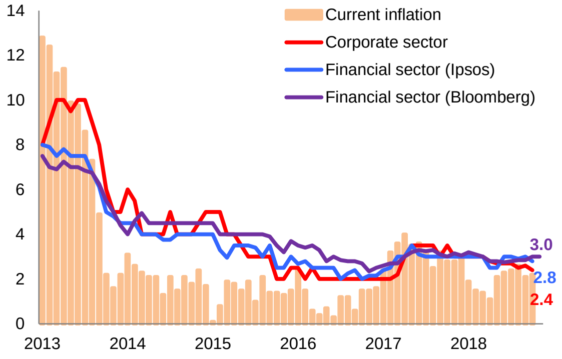
In accordance with our expectations from August, y-o-y inflation continued to move within the target tolerance band (3.0±1.5%) and reached 2.2% in October. More than a half of inflation concerned only two groups of products – petroleum products and fruits and vegetables. Second-round effects have not taken place – i.e. rising prices of petroleum products and unprocessed food did not spill over to other prices, which indicates confidence in NBS monetary policy. That inflationary pressures are low is also confirmed by core inflation, which is stable and at around 1% y-o-y, as well as the inflation expectations of financial and corporate sectors that are anchored around the 3% target.

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 %)



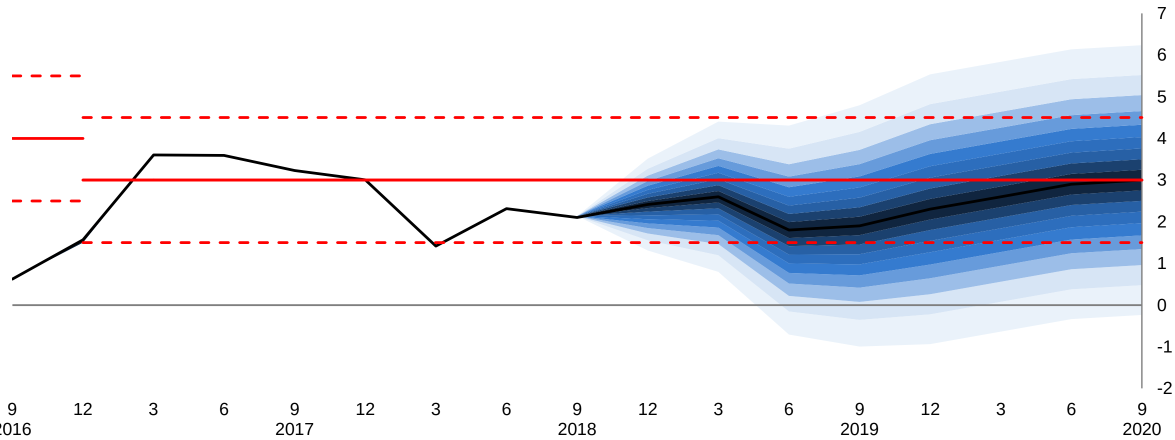
Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.

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

Under our central projection, which is almost unchanged relative to the August projection, y-o-y inflation is expected to continue to move within the target tolerance band in the next two years – below the target midpoint (3.0±1.5%) until end-2019, getting temporarily closer to it in the first months of 2019 owing to the low base effect.

Medium-term inflation movements will be under the dominant sway of aggregate demand. Disinflationary pressures generated by past appreciation of the dinar are expected to gradually wane. In the short run, disinflationary effect will come from low food production costs, and in 2019 also from this year's high base for fruit and vegetables and petroleum products. Working in the opposite direction will be the assumed administered price growth of 4%.

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



Source: NBS.

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In the period from August, the NBS Executive Board kept the key policy rate unchanged at 3.0%, its lowest level in the inflation targeting regime. In making the decision to keep the rate on hold, the Board was guided by expected movements in inflation and its underlying factors, and the effects of past monetary policy easing. Caution was mandated by uncertainty in the international financial and commodity markets, notably of crude oil and primary agricultural commodities.

Given that the key risks to monetary policy emanate from the international environment, the NBS will continue to carefully monitor and analyse trends in the international financial and commodity markets, and to assess their impact on economic developments in Serbia.

As so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium run, which will, along with the preservation of financial stability, contribute to sustainable economic growth and strengthen resilience to external uncertainties.

Finally, I would like to highlight that the November *Inflation Report* contains four text boxes on topical issues:

1. The first text box analyses the structure and terms of lending to small and medium-sized enterprises through the lenses of the new interest rate statistics.

2. The second text box elaborates on the significant improvement in Serbia's foreign trade position in the highly competitive global market in the 2012–2017 period.

3. The third text box focuses on the impact of the revision of GDP data in the 2015–2017 period on the most important macroeconomic indicators.

4. The fourth text box analyses rising trade tensions and their impact on economic developments in the world and at home.

Thank you for your attention. We remain at your disposal for any questions.