NATIONAL BANK OF SERBIA

Introductory address at the presentation of the Inflation Report – November 2019

Dr Jorgovanka Tabaković, Governor

Belgrade, 14 November 2019

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

Welcome to the presentation of the November *Inflation Report*.

Since our last gathering in August, inflation has remained low and stable, favourable fiscal trends have continued, while economic, investment and export activity gathered momentum. Stepped up investment deserves a special note, as it pushed GDP growth in Q3 beyond our expectations, prompting an upward revision of the 2019 growth forecast – to 3.6%, instead of the previous 3.5%. Given that domestic factors successfully compensate for the weaker external demand, favourable macroeconomic trends are expected to continue in the period ahead.

At this press conference we will present our view of the current and expected macroeconomic developments.

Inflation is low and stable for the sixth consecutive year and is expected to remain so in the period ahead.

Same as in the neighbouring countries, lower contributions of unprocessed food and energy prices set the y-o-y inflation in Serbia on a downward path over the past months. In October, inflation measured 1.0% y-o-y. Since the start of the year, core inflation has hovered between 1.1% and 1.5% y-o-y, suggesting that low inflationary pressures are of a more permanent nature, despite positive trends in the labour market.

According to our November projection, **inflation will continue to move at low levels in the coming period**, as confirmed by the inflation expectations of financial and corporate sectors for one and two years ahead.

Chart 1 **Contribution of CPI components to y-o-y inflation**
(in pp)

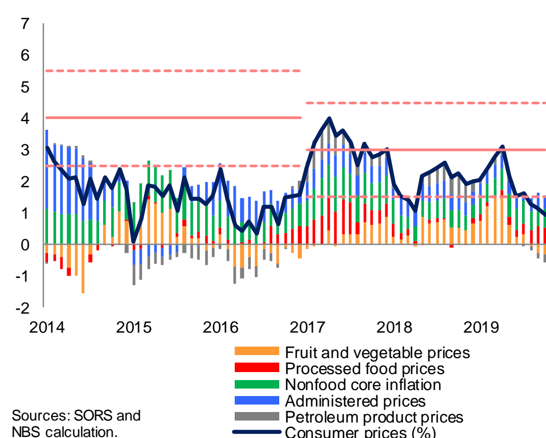
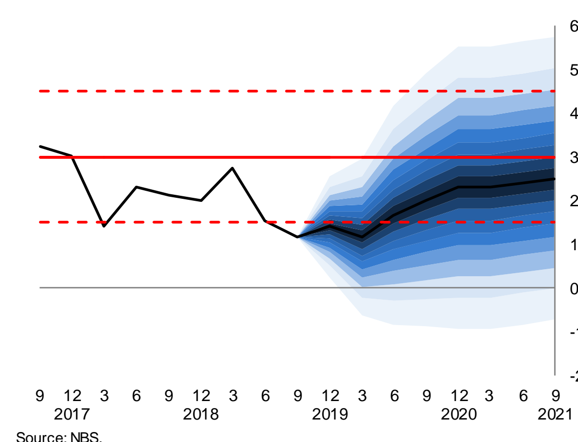


Chart 2 **Inflation projection**
(y-o-y rates, in %)



Source: NBS.

As a result of the preserved macroeconomic and financial stability and improved business environment, investment remains the key factor of economic acceleration.

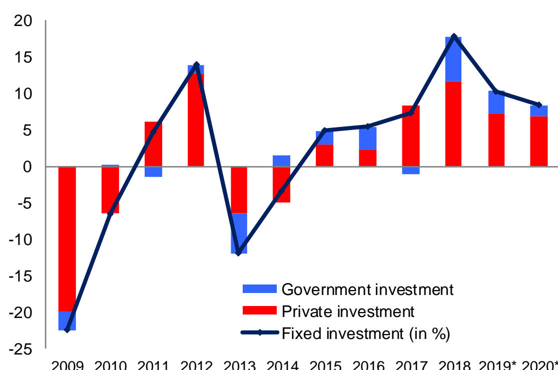
Economic activity has been on the rise for twenty quarters in a row. In Q3 2019, GDP growth sped up to 4.7% relative to the same period the year before. Given that external demand slowed down additionally, such growth acceleration is a signal of the rising contribution of domestic factors. The key factor of economic acceleration in Q3, on the production side, was the construction sector whose growth stepped up to around 35% y-o-y owing to intensified works on the transport and energy infrastructure. Faster economic growth was enabled by the activation of earlier investment, which helped the manufacturing exports to pick up from 5% in the first half of the year to almost 9% in Q3. Continued implementation of infrastructure projects, further improvement in the business environment

and favourable terms of financing gave an additional impetus to vigorous economic growth. Improvement in the business environment is also confirmed by Serbia's progress on the World Bank's latest Doing Business list, by four notches, to the 44th position among 190 countries.

In view of the results achieved, we have revised our GDP growth forecast for this year from 3.5% to 3.6%, though there is a realistic possibility that growth might turn out even higher. Growth is expected to pick up further to around 4% in 2020 and maintain similar dynamics in the medium term, driven by investment, exports and sustainably rising personal consumption.

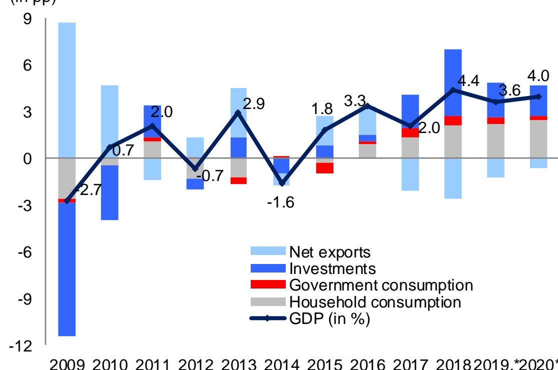
Consumption growth is also aided by the higher employment, owing to which the unemployment rate dropped to 10.3%, according to the latest available data. Taking into account the upward trend in labour market participation, the data on formal employment gains, good agricultural season and robust construction growth, we estimate that in Q3 the unemployment rate could edge down to a single-digit level.

Chart 3 **Fixed investment**
(y-o-y growth, in pp)



Sources: SORS and NBS calculation.
* NBS estimate.

Chart 4 **Contributions to y-o-y GDP growth rate – expenditure side**
(in pp)



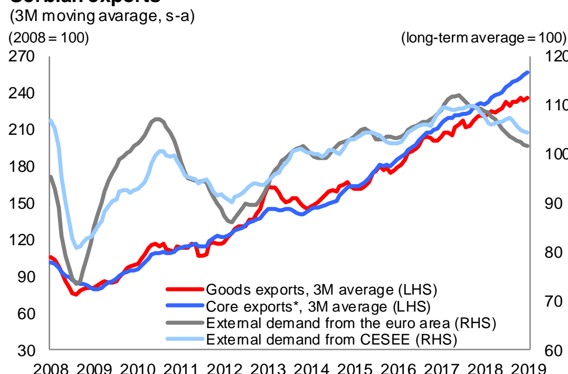
Sources: SORS and NBS calculation.
* NBS estimate.

Exports have stepped up, despite slackening external demand. Capital inflows to Serbia remain high.

In the first nine months of 2019, Serbia's goods and services exports went up by 10.9%, and those destined to the EU by 10.6% compared to the same period last year. Thus, **the overall export growth rate stepped up compared to 2018, coming close to the import growth rate** (11.6% y-o-y). Import

dynamics is determined primarily by the investment cycle at home and the consequently higher needs for equipment and intermediate goods, which is connected with the high FDI inflow and partly also fuelled by the rising consumer demand. On those grounds, the current account deficit will expand in the

Chart 5 **Movement of indicators of external demand for Serbian exports**
(3M moving avarage, s-a)



Sources: European Commission, SORS and NBS.
* Core exports are total exports excluding exports of agricultural products, base metals, motor vehicles, petroleum products and electricity.

Chart 6 **FDI structure by sector**
(in %)

Source: NBS.
Note: Preliminary data for H1 2019.
* Agriculture, industry, mining, transportation, catering.

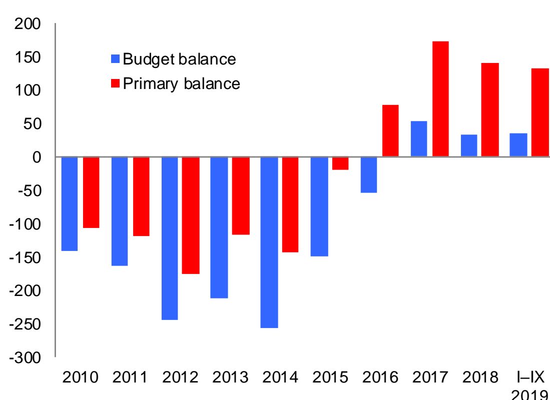
short run, but given that the imported equipment continuously increases export capacities of the Serbian economy, it is reasonable to expect that the deficit will decrease in the medium-run. **Since the start of the year FDI inflow has reached EUR 2.9 bn, covering, in net amount, the current account deficit for the fifth year in a row.** Together with reduced internal and external imbalances, FX reserves, which reached the record EUR 13.5 bn at end-October, have additionally increased the resilience of our economy to potential adverse developments in the international environment.

Favourable macroeconomic landscape is crowned by the elimination of fiscal imbalances, thanks to the full coordination of monetary and fiscal policy measures.

As the previous two years, 2019 has seen a fiscal surplus which on consolidated level reached 0.9% of GDP concluding with September. Central government public debt was reduced additionally, to 52.0% of GDP at end-September.

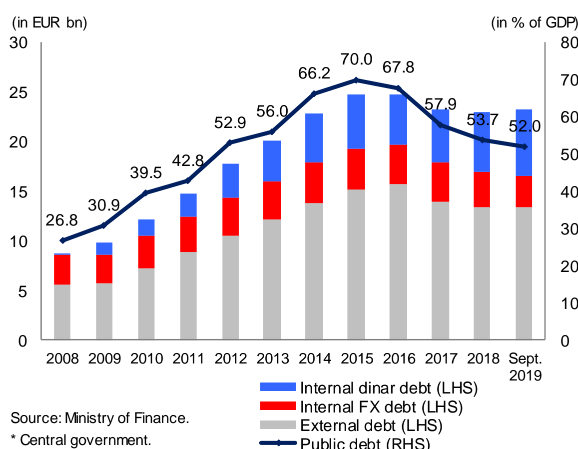
It is important to note that these results have been achieved in conditions of significantly higher government capital expenditure, as well as increased outlays for wages and pensions, which contribute to economic growth while causing no major inflationary pressures. General government deficit planned for this year is 0.5% of GDP, which is also a medium-term target that will keep the public debt-to-GDP ratio on a downward path. No less importantly, the currency and refinancing risks are also reduced, supported by the last week's successful reissue of the ten-year eurobond in the international financial market. The bond was sold at the lowest rate of return so far – 1.25%, which are the terms enjoyed by countries with investment grade rating. The funds raised are intended exclusively for the repayment of the earlier expensive dollar debt, which means that this issue does not increase public debt, while it does cut down interest expenses.

Chart 7 **General government fiscal and primary budget balance**
(in RSD bn)



Source: Ministry of Finance.

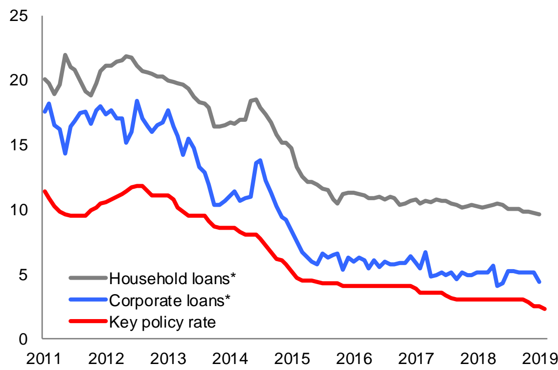
Chart 8 **Public debt***



By lowering the policy rate, we have provided further support to credit and economic activity.

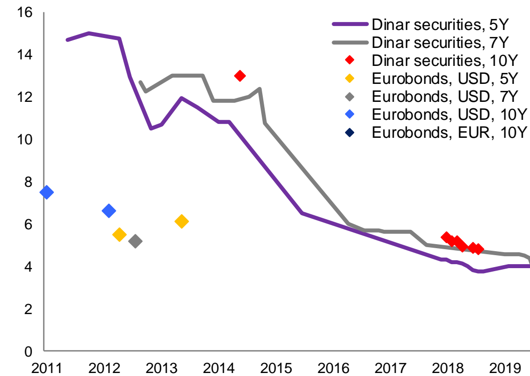
Additionally weakened inflationary pressures, reduced internal and external imbalances and the consequently strengthened resilience of our economy to potential negative impacts from the international environment, as well as the favourable macroeconomic outlook, have created room for further monetary policy easing. **In November, the key policy rate was again cut by 25 basis points, to 2.25%.** Apart from domestic factors, this decision was also motivated by the monetary policy accommodation of leading central banks, against the background of a slowdown in global trade and economic growth. We expect that the NBS's monetary policy easing will, as so far, lead to a fall in interest rates in the money and credit markets.

Chart 9 **Interest rates on new dinar loans**
(weighted average values, p.a., in %)



Source: NBS.
* Excluding revolving loans, current account overdrafts and credit card debt.

Chart 10 **Interest rates in the primary market of dinar government securities and eurobonds**
(p.a., in %)



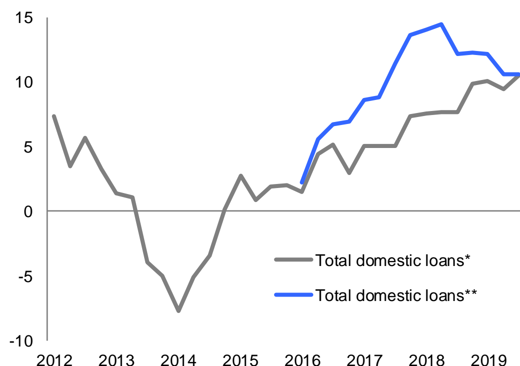
Source: Ministry of Finance.

Strong credit growth at favourable conditions gives significant support to economic growth.

Favourable financial conditions in the domestic market are also evidenced by the lending interest rates, which in the dinar market fully mirrored the NBS's monetary policy easing. As for the euro-indexed loans, favourable terms of financing were supported by the lower interest rates in the European money market and, to a greater extent, also by the decline in Serbia's risk premium. What I want to emphasize particularly is that Serbia's risk premium is now among the lowest in the region and that its sharp fall was largely driven by domestic factors. In the past months, the risk premium dropped several times, to even below 50 basis points, while on 12 November it touched its lowest value of 34 basis points. I would further like to point out that Serbia is only a step away from investment grade, characteristic of economies offering high security of investment, which not only confirms the economic progress and the results achieved, but also contributes to further improvement of financing and investment conditions in Serbia.

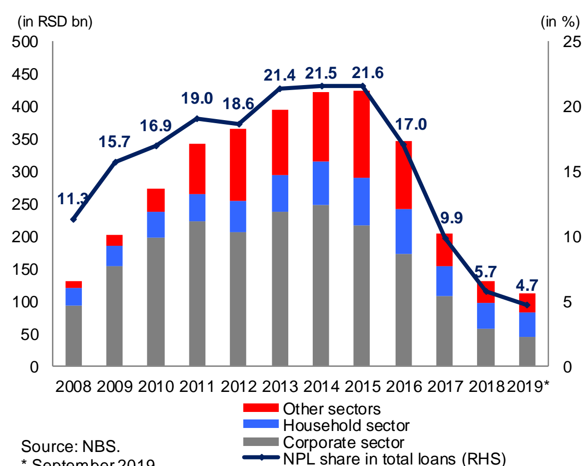
A decrease in interest rates, coupled with economic growth and positive trends in the labour market, gives rise to lending. The structure of lending is favourable in terms of support to sustainable economic growth, as evidenced by a significant rise in corporate investment loans and a rebound in household housing loans, with a mild deceleration in the growth of loans intended for consumption. While lending has recorded two-digit y-o-y growth rates, loans have a stable share in GDP, posing no risk to either price or financial stability. The reduction in the share of NPLs in total loans to 4.7% has created room for further credit growth and at the same time reinforced financial stability.

Chart 11 **Lending activity and GDP**
(y-o-y rates, in %)



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

Chart 12 **NPL share in total loans, gross principle**



Source: NBS.
* September 2019.

Ladies and gentlemen, dear colleagues,

Allow me to round off this part of the conference by concluding that the results achieved have been enabled by the full coordination of monetary and fiscal policy measures, which has strengthened the credibility of economic policy. This credibility is confirmed by the already mentioned credit rating upgrade, low risk premium, more favourable position of Serbia in the international financial market, as well as by the high FDI inflow. Such approach to the conduct of economic policy has ensured an adequate response to the challenges from the international environment which the country faced in the past and will surely face going forward. In the period ahead, you can count on our full commitment to the safeguarding of the achieved stability which, along with further implementation of structural reforms, will boost the competitiveness of our economy, as well as employment and the living standard of our citizens.

I will now hand over to my colleagues from the Economic Research and Statistics Department to give you a detailed account of our latest macroeconomic projections.