NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report – November 2019

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Economic Research and Statistics Department

Belgrade, 14 November 2019

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

We shall now present our new projections regarding inflation, economic activity and other key macroeconomic indicators.

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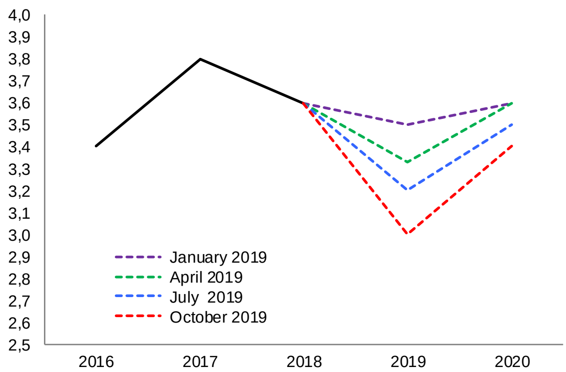
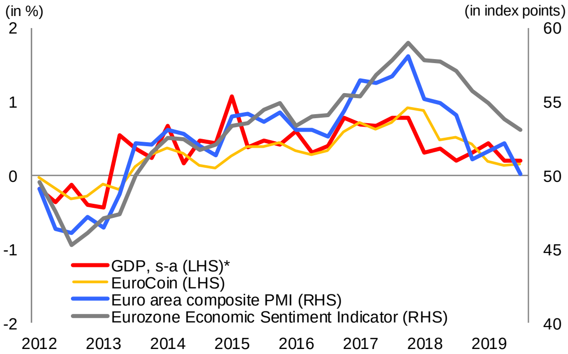
It is already certain that the year 2019, at a global level, will be marked by a significant slowdown in trade and economic growth due to the rising protectionism and uncertainty in terms of future trade policies of leading world economies. The relevant international institutions have once again revised down their global growth estimates, including the estimate for the euro area, Serbia's key foreign trade partner, noting that global growth will nevertheless pick up gradually in the coming period. Unlike in euro area countries, growth in countries in our region, which are also Serbia's important trade partners, remained largely unchanged owing to increased reliance on domestic demand, which has been accounted for in our new projection. Also, **our new inflation projection takes into account the lower inflation projection in the international environment, notably the euro area, and consequently the weaker pressures on account of import prices**.

Chart 1 **IMF global growth projections**
(in %)



Source: IMF WEO.

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

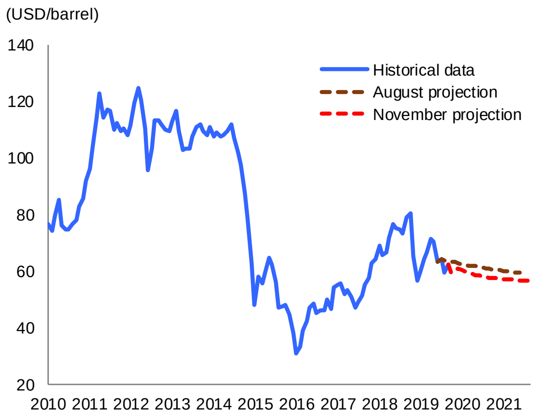


Sources: Eurostat, Markit Group, Banca d'Italia and European Commission.
* Eurostat preliminary estimate for Q3 2019.
** ESI is standardised relative to PMI.

An impulse to global growth is expected to come from increased accommodation of leading central banks' monetary policies going forward. The September package of the ECB's expansionary measures, which includes the renewal of the asset purchase programme, is the largest in three years. Also, the Fed continues to pursue an expansionary monetary policy by trimming its federal funds rate and increasing its balance sheet via interventions in the money market. This should translate into **more favourable terms in the international financial market, which we took into account when drafting the projection.** Still, it remains uncertain to which degree the future moves by leading central banks will differ from market expectations, which mandates caution because of its possible impact on global capital flows.

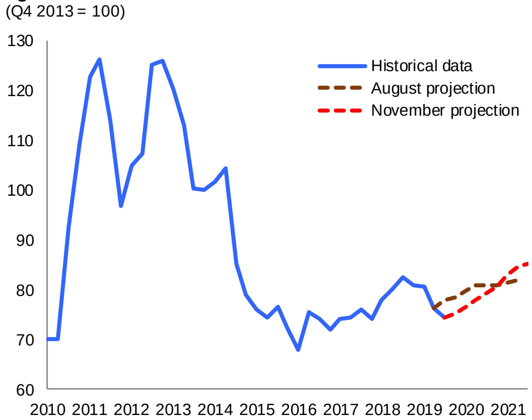
As for the international commodity market, uncertainty regarding future developments pertains primarily to movements in the price of oil. After rising in mid-September, the global oil price declined and in October it went below USD 60 per barrel, meaning it was around 7% lower than three months ago. In accordance with futures, **our new projection assumes slightly lower oil prices in the global market** relative to three months ago. Given the instability of global supply and demand, the price of oil is equally likely to move either way. Based on futures, we drew the **assumption on movements in the prices of primary agricultural products, where we anticipate a somewhat greater fall this year, followed by a higher rise over the next two years** relative to the previous projection.

Chart 3 **Assumption for Brent oil prices**



Source: Bloomberg.

Chart 4 **Assumption for international prices of primary agricultural commodities**



Sources: CBOT, Euronext and NBS calculation.

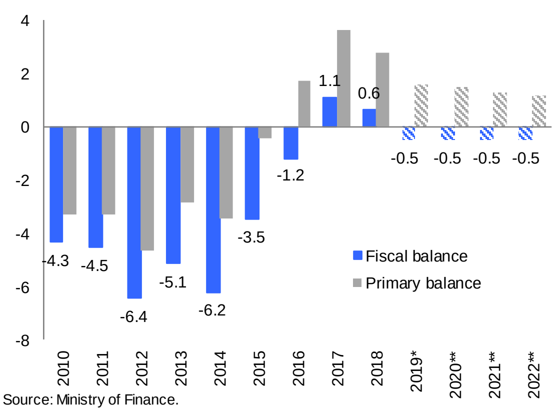
Contrary to uncertainty in the international environment, **domestic conditions for monetary policy implementation were characterised by continued macroeconomic improvements underlying our projection**.

Despite conditions that include significantly higher government capital expenditure and increased wage and pension outlays, we had a surplus in the consolidated budget in excess of RSD 35 bn in the first nine months of the year. Owing to eliminated fiscal imbalance, the share of public debt in GDP decreased to 52.0% at end-September and is expected to remain on the downward path going forward. **Our projection assumed that the character of the fiscal policy will be mildly expansionary over the projection horizon, without major pressures on inflation growth.**

The projection assumption includes a stable external position in the coming period as well. We estimate that this year's share of the current account deficit in GDP will remain similar to last year's, and gradually decrease over the coming years. Investments channelled to tradable sectors, as well as the gradual recovery in external demand are likely to speed up export growth in the period ahead. Owing to the continuation of the investment cycle, we expect to see increased import of equipment and intermediate goods, while the improved living standard of citizens and rising consumer demand will lead to a moderate rise in the import of consumer goods. We expect **this year's FDI to reach the level from last year and that their net amount, for the fifth consecutive year, will more than fully cover the current account deficit**. That deficit will be more than fully covered by FDIs is our expectation going forward as well, as is the continuation of good investment diversification, leading to further growth in

Chart 5 **Consolidated fiscal balanse**

(% of GDP)



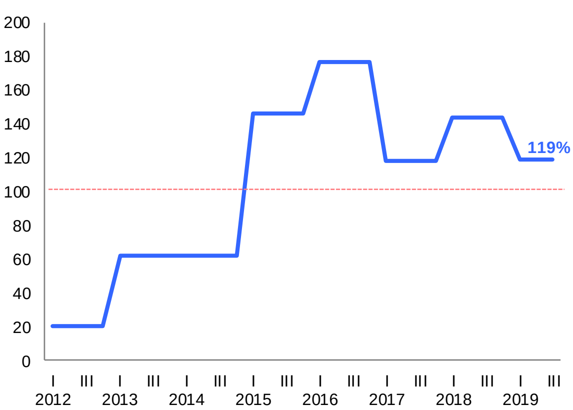
Source: Ministry of Finance.

* Estimate.

** Projection.

Chart 6 **FDI coverage of current account deficit**

(p.a., in %)

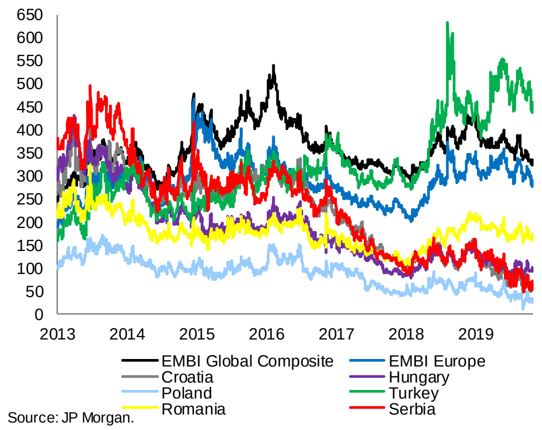


Source: NBS.

the country's export potential.

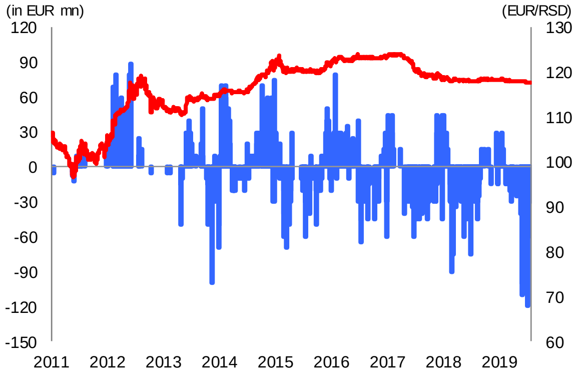
Balanced public finance and the country's stable external position are reflected as a **fall in the risk premium and improved credit rating, which is conducive to relative stability in the foreign exchange market.** Appreciation pressures, which prevailed in the previous period, continued on, and the NBS intervened to ease excessive short-term fluctuations of the dinar exchange rate to the euro. Since the start of the year, the NBS bought EUR 2.5 bn net in the foreign exchange market, thus building up the country's foreign exchange reserves.

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



Source: JP Morgan.

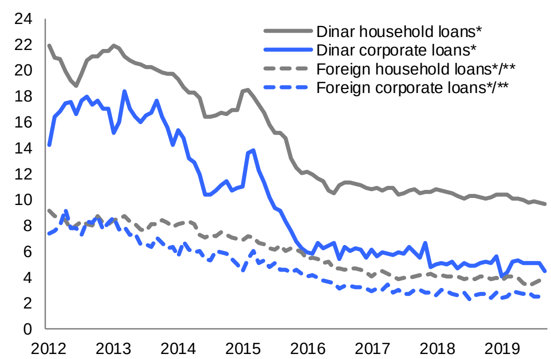
Chart 8 **Movements in EUR/RSD exchange rate and NBS FX interventions**



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

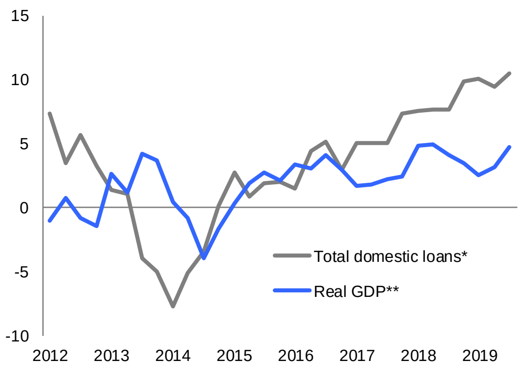
Consistent with our projection, the costs of government and private sector financing are still relatively low. The key policy rate was trimmed for the third time this year, to 2.25% in November, which is its lowest level in the inflation targeting regime. We anticipate that the NBS's monetary policy easing, coupled with the country's low risk premium, will reflect positively on financial conditions and a further decline in interest rates. Lower costs of financing will support the **further rise of lending** and, in turn, growth in investment and overall economic activity.

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



Source: European Banking Federation and NBS.
* Excluding revolving loans, current account overdrafts and credit card debt.
** Euro and euro-indexed.

Chart 10 **Lending activity and GDP**
(y-o-y rates, in %)



Sources: NBS.
* Excluding the exchange rate effect.
** NBS estimate for Q3 2019.

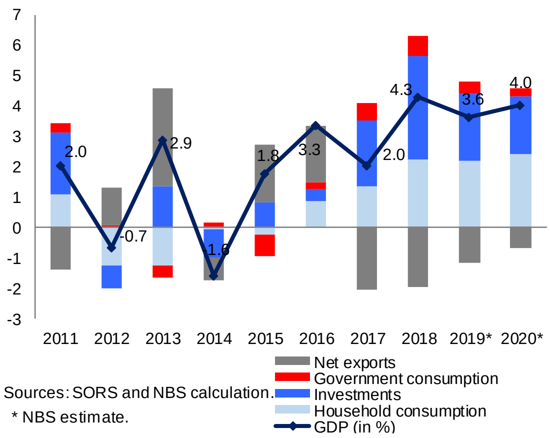
* * *

Domestic drivers of economic growth helped speed up economic activity in Q3 more than we anticipated – estimated GDP growth is 4.7% y-o-y. Growth is driven by construction, services sectors and the expected recovery in manufacturing, and on the expenditure side by investments and improved foreign trade balance.

Economic activity will most likely maintain the relatively strong dynamics in Q4, therefore we expect **GDP growth to reach 3.6% this year**, instead of the previously expected 3.5%. Investments are still the key factor of economic growth, owing to the ongoing realisation of infrastructure projects and private sector investments attributable to the improved business climate and favourable sources of funding. Investment growth spilled over onto other components of GDP. We recorded a further increase in household consumption, mainly owing to positive labour market developments and lower costs of borrowing. On the other hand, the investment cycle in the country and the associated equipment import, as well as the further slowdown in external demand, are yielding a negative contribution to net exports, though lower than in the first half of the year due to the accelerated rise in manufacturing exports.

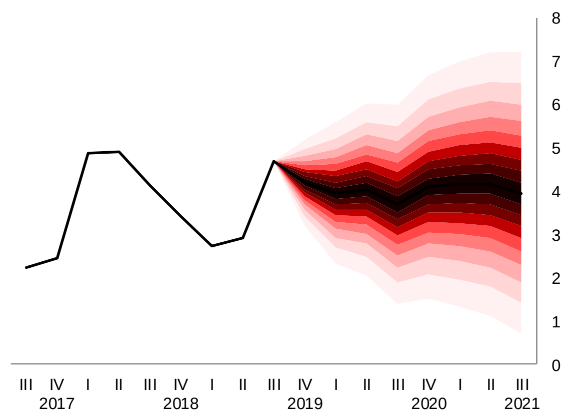
According to our projection, we expect GDP growth in 2020 to accelerate to around 4% and maintain similar dynamics in the medium term, on the back of investments, export and a sustainable rise in household consumption. Risks to the GDP projection in the medium term are judged to be symmetric, with risks emanating from the international environment being estimated as tilted to the downside, and those arising from the domestic environment to the upside.

Chart 11 **Contributions to annual GDP growth**
(in pp)



Sources: SORS and NBS calculation.
* NBS estimate.

Chart 12 **GDP growth projection**
(y-o-y rates, in %)

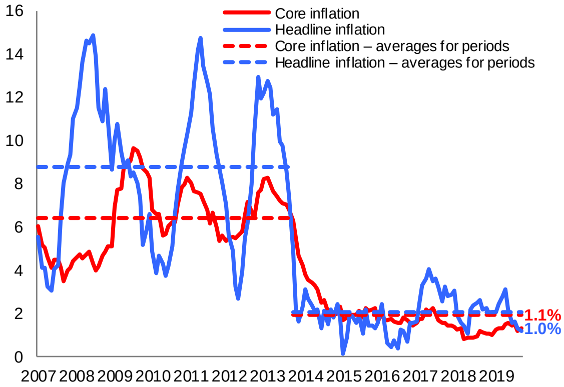


Source: NBS.

* * *

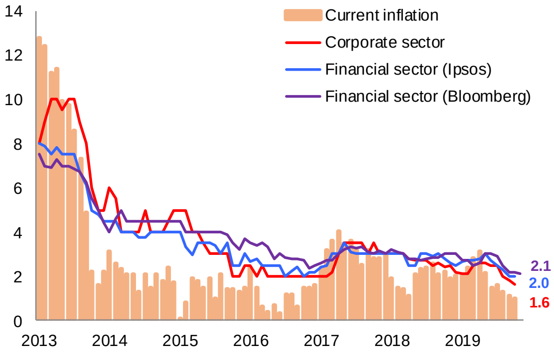
Having reached the central midpoint in April, y-o-y inflation slowed down to 1.0% in October, responding to the lower prices of vegetables and petroleum products. Core inflation is also low, measuring 1.1% in October, which is slightly below the level at which it trended since the start of the year. **Low inflationary pressures are also indicated by expectations of the financial and corporate sectors**, which are trending in the lower half of the target band in both short and medium term, in accordance with the NBS projection.

Chart 13 **Headline and core inflation**



Source: SORS and NBS calculation.

Chart 14 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, in %)



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

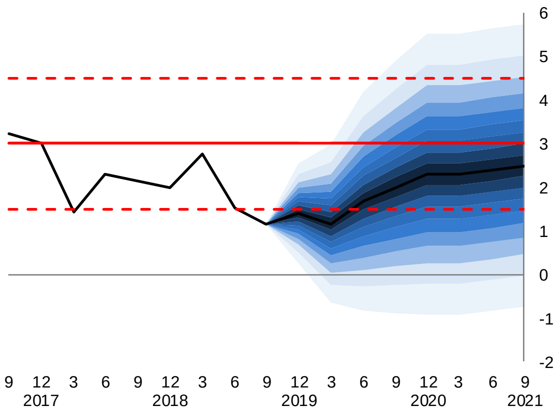
* Ipsos and Gallup agencies until December 2014, Ninamedia agency since December 2014, and Ipsos agency since January 2018.

According to the November central projection as well, we expect y-o-y inflation to remain low and stable until the end of the projection horizon – until mid-2020 it will hover around the lower bound of the target tolerance band, only to come gradually closer to the central midpoint thereafter. In the short term, this will be facilitated by the low base from the prices of vegetables and administered prices, and in the medium term by rising aggregate demand.

The current inflation projection until mid-2020 is lower than the August projection, mostly because the fall in vegetable prices in Q3 was greater than expected. This drove the inflation projection down until the middle of next year and increased it thereafter, due to the low base effect.

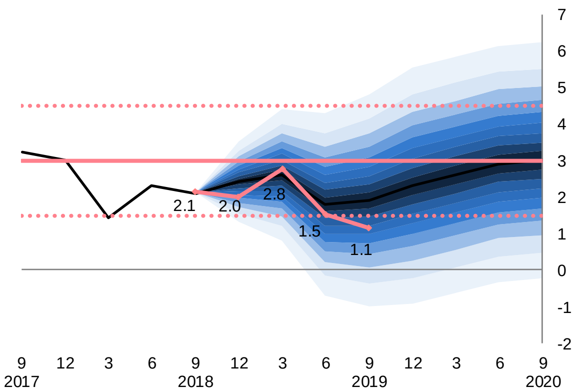
Uncertainty surrounding the inflation projection is associated primarily with movements in international commodity and financial markets and, to a degree, to the rise in administered prices. Taken together, the risks to the inflation projection are judged to be symmetric.

Chart 15 **Inflation projection**
(y-o-y rates, in %)



Source: NBS.

Chart 16 **Achievement of November 2018 inflation projection**
(y-o-y rates, in %)



Source: NBS.

Allow me to take a brief look at our inflation projection that was presented in November 2018, because this is the monetary policy horizon, i.e. the period in which its full effects on inflation become evident. As you can see, **until the middle of this year, inflation moved in line with the projected central level from a year ago, while in Q3 it was below that level due to a sharper decline in global oil prices and slower growth in administered prices than anticipated a year ago.** Global oil prices were lower by around 20% than we assumed one year ago, according to futures, hence the prices of petroleum products at home were also lower, as was their contribution to inflation. Administered prices also yielded a lower contribution, as their growth in Q3 was more modest (2.1% y-o-y) than what was assumed in the November 2018 projection.

To conclude, I would like to remind you that **inflation in Serbia is low and stable – averaging 2% in the past six years**, which is the level of inflation in advanced countries. In the period ahead, the NBS will continue to maintain efficient control of inflation and inflation expectations as this is the best way to preserve the confidence we have built up, as well as the efficiency of our monetary policy.

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Ladies and gentlemen, dear colleagues,

At the end of my presentation, I would like to emphasize once again that the November *Inflation Report* contains five text boxes covering current topical issues:

1. The first text box presents the current trends in lending;
2. The second text box analyses the trends and growth prospects of household consumption going forward;
3. The third text box focuses on the rise in Serbia's export, which is high and diversified, despite a slowdown in global demand;
4. The fourth text box analyses positive labour market trends at home;
5. The fifth text box looks into the new monetary policy measures by the ECB and Fed, and their potential impact on Serbia.

Thank you for your attention.