NATIONAL BANK OF SERBIA

Speech at the presentation of the *Inflation Report* – February 2020

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Economic Research and Statistics Department

Belgrade, 19 February 2020

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

We shall now present to you our latest macroeconomic projections and monetary policy decisions, and the underlying domestic and international factors.

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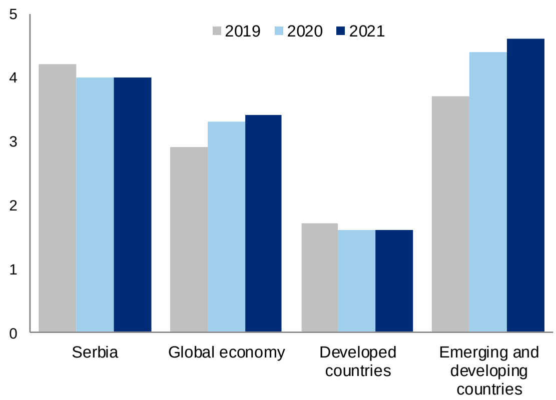
Bolstered economic fundamentals lie at the core of the increasingly better outlook for our economy. We expect inflation to remain low and stable in the next two years, and to gradually approach the target midpoint of 3%. Economic growth and a rise in the standard of living will continue on sustainable grounds. Domestic factors are expected to be the main drivers of growth, amidst external risks that may act as a dampener.

After hitting its record low in the past ten years, the global growth is anticipated to gradually recover this year, despite the **prevailing negative risks**. They relate primarily to potential re-escalation of trade and geopolitical tensions which marked last year. The coronavirus risk recently appeared as well and may affect global growth in the short run.

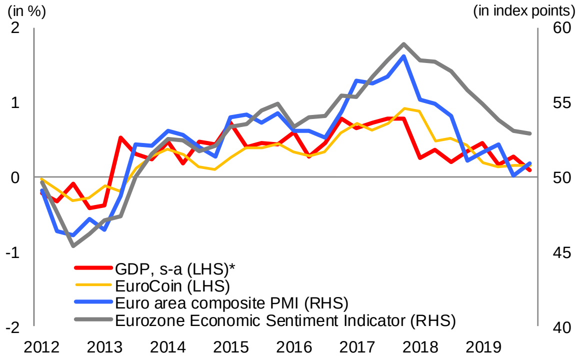
In regard to **growth in the euro area**, our most important trade partner, the current projection assumes the growth of 1.1%, which is consistent with the latest projection of the European Central Bank in which growth for this year was revised slightly down. As in the previous projection, euro area growth is expected to accelerate to 1.4% next year. The expected growth in **countries of the region**, which are also our important trade partners, remained unchanged, owing to greater reliance on domestic demand, which we took into account in the new projection. As euro area inflation is expected to recover somewhat, the current projection does not anticipate growth in inflationary pressures **based on import prices**.

Chart 1 **Real GDP growth projection for 2020 and 2021**
(in %)



Sources: NBS and IMF WEO Update, January 2020.

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



Sources: Eurostat, Markit Group, Banca d'Italia and European Commission.

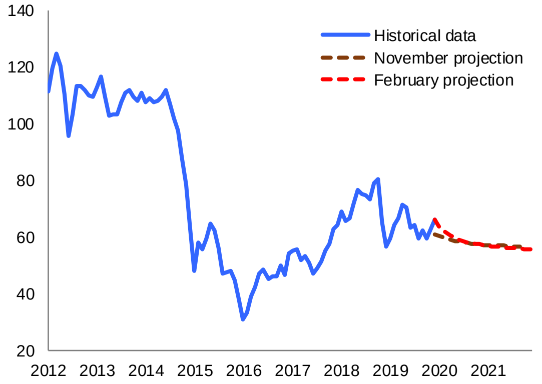
* Eurostat preliminary estimate for Q4 2019.
** ESI is standardised relative to PMI.

Given the expected relatively slow global growth and muted inflation, **conditions in the international financial market are likely to remain favourable**. The European Central Bank continues with quantitative easing, with markets expecting the accommodation to last longer than it was expected three months ago. Markets still expect further cuts in the federal funds rate, though such steps are not being announced for the time being, with the Fed's latest projections being at a lower level than three months ago. It remains uncertain **to what extent the future moves of leading central banks will deviate from market expectations, which mandates caution because of the potential impact on global capital flows**.

Uncertainty in the international commodity market concerns primarily the **global oil price**, which was rather volatile over the past months. After rising close to USD 70 per barrel in late last and early this year, the global oil price fell to current c. USD 55 per barrel. In line with futures, **global oil prices are expected to remain unchanged from the previous projection**. Given the instability of global supply and demand, shifts in the oil price are possible in both directions. Based on futures, we also made the **assumption about the movement of prices of primary agricultural commodities, which are expected to rise somewhat less both this and next year** compared to the previous projection.

Chart 3 **Assumption for Brent oil prices**

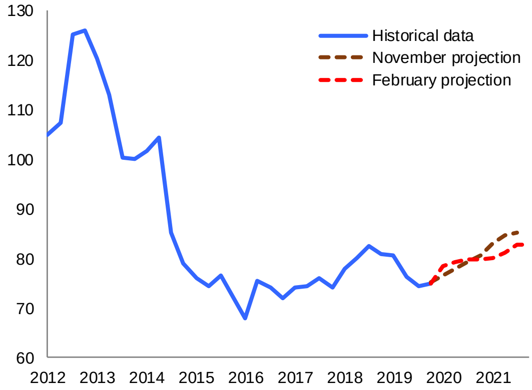
(USD/barrel)



Source: Bloomberg.

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

(Q4 2013 = 100)



Sources: CBOT, Euronext and NBS calculation.

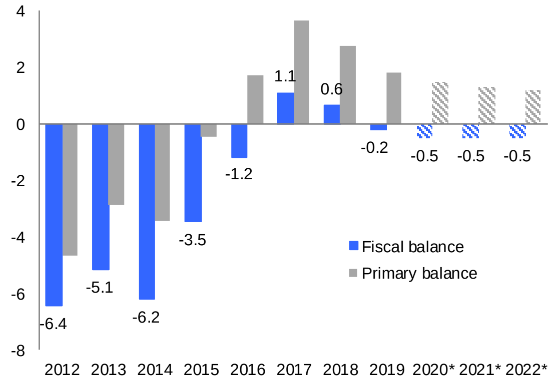
In contrast to uncertainty abroad, **domestic factors are continuing to contribute to macroeconomic stability and sustainable economic growth, which underpins our projection.**

Even against the background of much higher government capital expenditure and increased outlays for wages and pensions, the consolidated budget deficit is smaller than planned in 2019, and the public debt share in GDP is on a downward trajectory. **We assumed that the fiscal policy stance in the projection horizon will be slightly expansionary, without major upward pressures on inflation**.

The inflation projection rests on the assumption of a stable external position in the coming period as well, with a net inflow of foreign direct investment continuing to fully cover the current account deficit. Over 60% of foreign direct investments are estimated to be channelled to tradable sectors, with increasing presence of smaller projects, which, in addition to boosting the export potential, increase the country's resilience to potential external shocks.

Chart 5 **Consolidated fiscal balance**

(% of GDP)

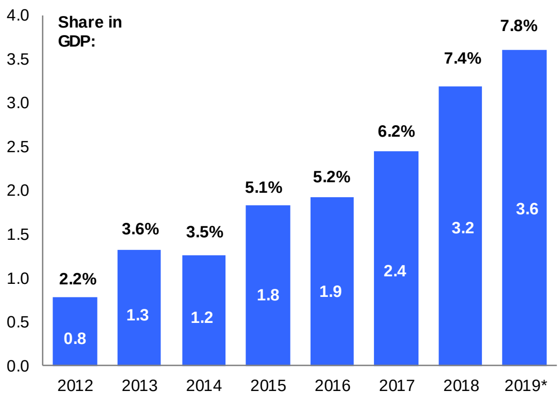


Source: Ministry of Finance.

* Projection.

Chart 6 **Net FDI**

(in bn EUR)

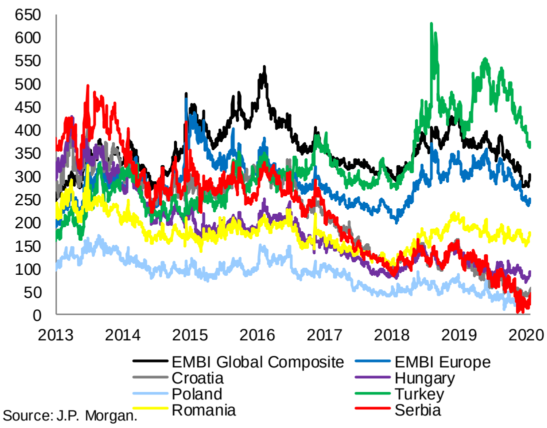


Source: NBS.

* Preliminary.

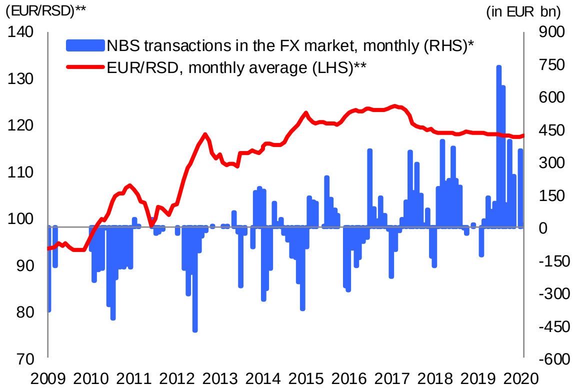
Balanced public finance and a stable external position of the country reflect on a **further decline in the risk premium, contributing to relative stability in the FX market**. Appreciation pressures, which prevailed in the prior period, continued, and the NBS intervened to mitigate excessive short-term volatility of the dinar against the euro. In the last quarter of 2019, the NBS bought EUR 805.0 mn and sold EUR 215.0 mn in the FX market. On this account, FX reserves expanded by EUR 2.7 bn at the year-level.

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



Source: J.P. Morgan.

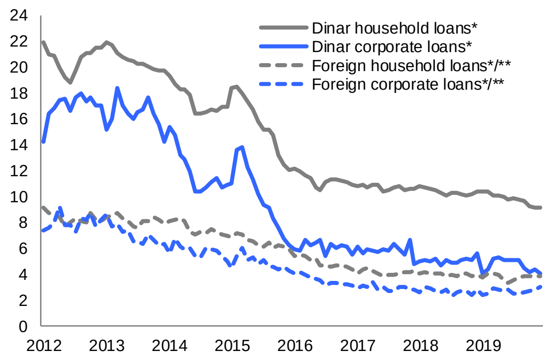
Chart 8 **Dinar exchange rate and NBS transactions in the FX market**



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

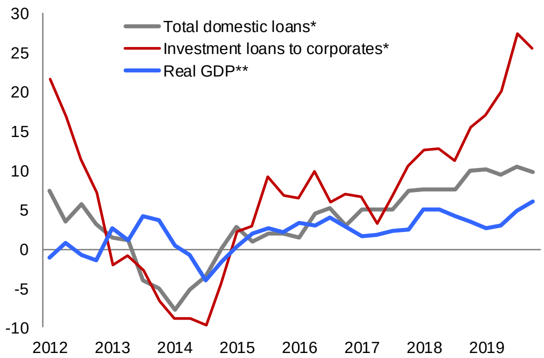
Consistent with our projection are the still relatively low costs of government and private sector financing. The key policy rate was cut three times last year, to 2.25% in November, which is its lowest level in the inflation targeting regime. This **monetary policy stimulus is being transferred to the real sector**, through more favourable financial conditions and further lowering of interest rates, which contributes to almost two-digit y-o-y growth in loans, notably investment loans. Lower costs of financing are expected to continue to prop up investment and consumption, and thus overall economic activity in the coming period as well.

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



Sources: 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 %)



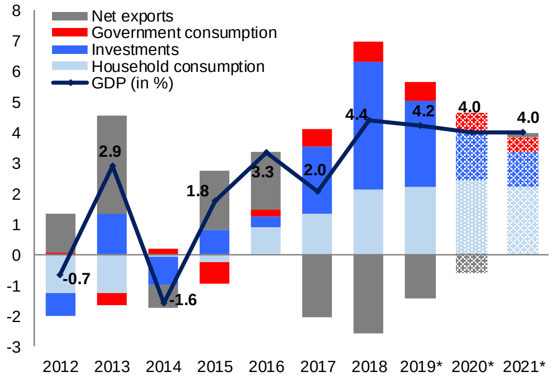
Sources: NBS.
* Excluding the exchange rate effect.
** NBS estimate for Q4 2019.

In the second half of last year, economic activity rose more than expected, pushing the annual growth to 4.2%. **The key underlying factor were fixed investments**, whose share in real GDP continued up – to 23.9% in 2019. The growth in their share was also projected for the coming period, to around 24.5% in this and the following year, owing to continued implementation of infrastructure projects and private sector investments reflecting improvement in the business environment and favourable sources of financing.

The investment cycle at home and the related increase in equipment imports will lead to the **negative net exports contribution, though lower than in the year before**, thanks to the activation of investments and the expected recovery of external demand. The rise in household consumption is also expected to continue on sustainable grounds, reflecting mainly positive labour market trends and lower cost of credit.

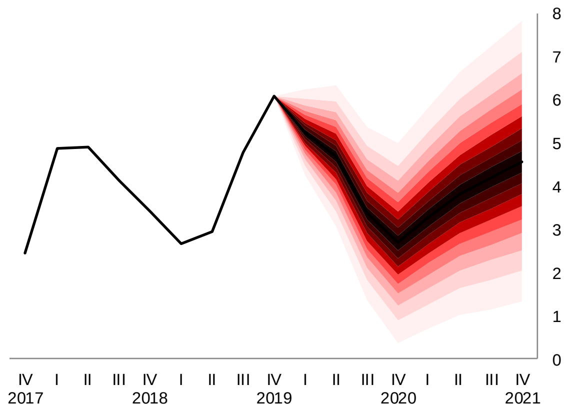
Considering the above assumptions, the **GDP growth projection for 2020 and 2021 was kept at 4%**, except that the risks stemming from the international environment are assessed as asymmetrical to the downside, and risks from the domestic environment to the upside, mostly due to a potential faster than expected rise in investments, as was the case in the previous two years.

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.

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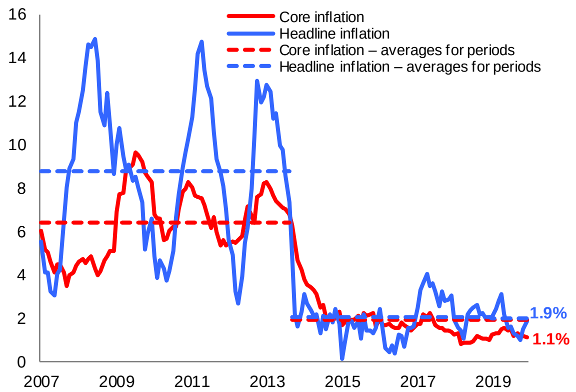
Despite the expansion in economic activity and positive labour market trends, inflation **remained low and stable in 2019 as well** – at 1.9% y-o-y in December. The inflation profile was largely determined by the unprocessed food and energy prices, which mirrored the price dynamics in the global market. Core inflation, which excludes the prices of food and energy, alcohol and cigarettes, averaged 1.3% at year-level.

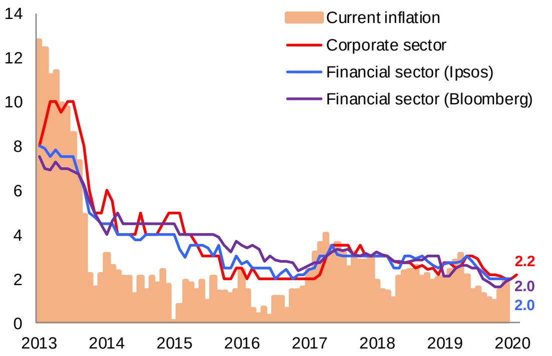
Inflation expectations of the financial and corporate sectors, which continued to move in the lower half of the target tolerance band for both one and two years ahead, **also point to low inflationary pressures.**

Chart 13 **Headline and core inflation**
(y-o-y rates, in %)



Sources: SORS and NBS calculation.

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



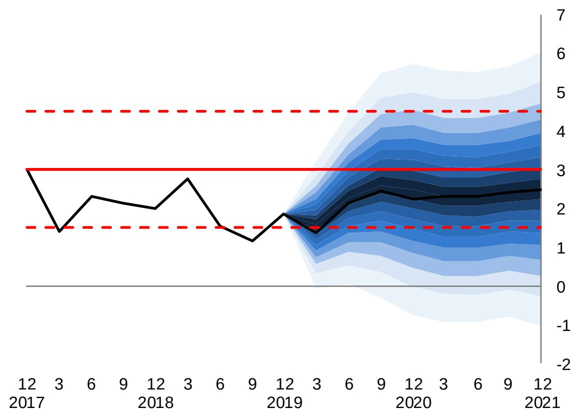
Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.
* Ipsos and Gallup agencies until December 2014, Ninamedia agency since December 2014, and Ipsos agency since January 2018.

According to the February central projection, y-o-y inflation is expected to remain low and stable until the end of the projection horizon – by mid this year it will move around the lower bound of the target tolerance band and gradually approach the target midpoint thereafter, driven mainly by the low base in vegetable prices in the short run and a rise in aggregate demand in the medium run.

Relative to the November projection, the current inflation projection for 2020 is somewhat higher, and almost at the same level in the next year, due to the higher rise in food prices in Q4 2019. Same as in the previous projection, the central inflation projection does not exceed the NBS inflation target of 3% in the next two years.

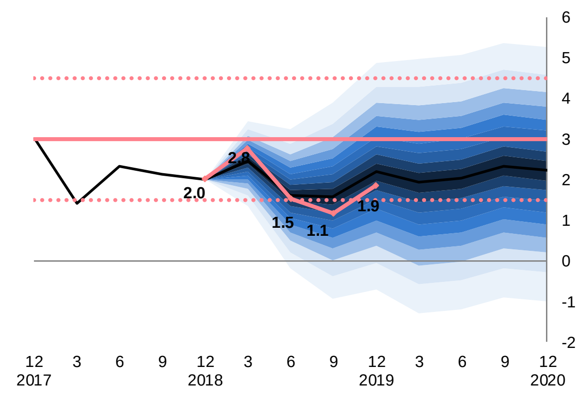
Uncertainties surrounding the inflation projection are associated primarily with the movements in the international commodity and financial markets and, to a lesser extent, the rise in administered prices, the agricultural season and domestic demand. On the whole, risks to the projection are judged to be symmetric.

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



Source: NBS.

Chart 16 **Achievement of February 2019 inflation projection**
(y-o-y rates, in %)



Source: NBS.

Finally, let me briefly dwell on our inflation projection from a year before. As you can see, **throughout the last year, inflation moved almost fully in line with the central values projected and published in our *Inflation Report* in February 2019.** We believe that such results bolster confidence in the National Bank of Serbia and help anchor the inflation expectations. As so far, we will continue to firmly control inflation, since that is the best way to preserve the gained confidence and the efficiency of the monetary policy, while contributing to the country's economic growth and development.

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