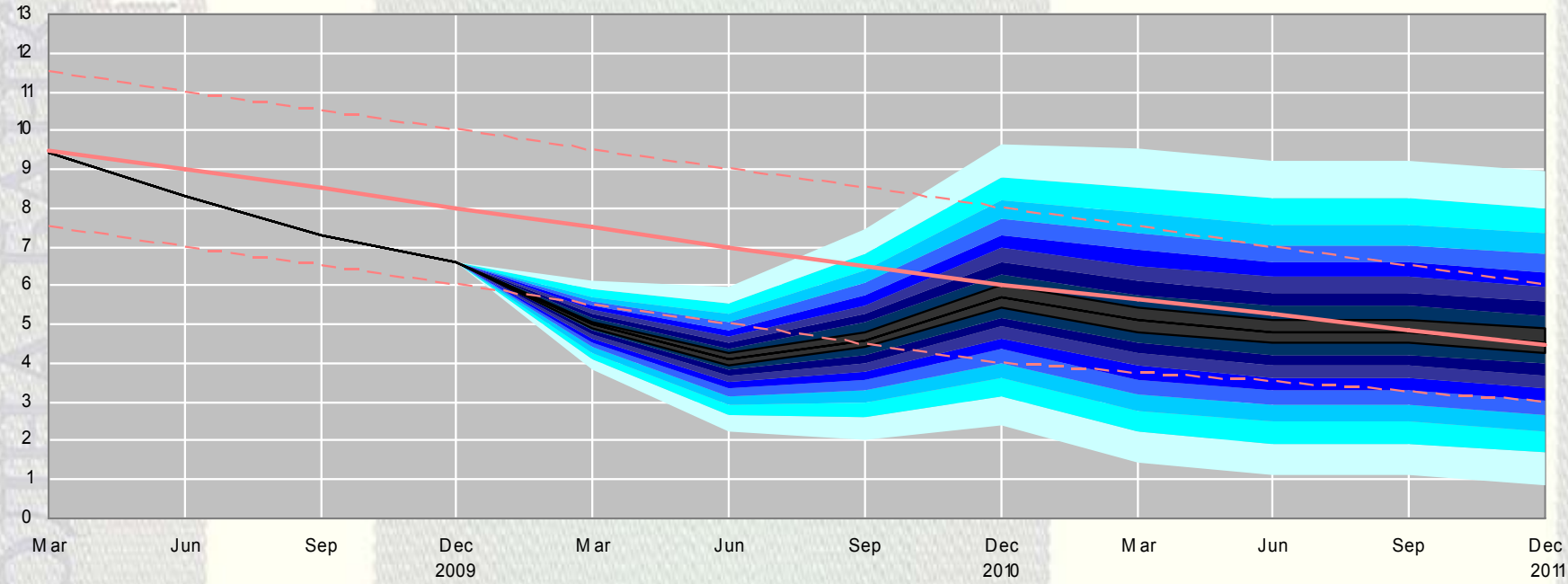
Inflation Report – February 2010

Belgrade, 25 February 2010

Inflation projection

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



- In January 2010, inflation measured 4.8% y-o-y.
- Inflation will most probably move below the lower bound of the target band in H1 2010, and trend closer to the target (6±2%) by year-end.
- In late 2010 and throughout 2011 inflation is expected to revolve around the target.

Key messages of the February *Inflation Report*

- Inflation moved within the target band throughout 2009, save in October and November when it fell below the lower bound of the target band. Low aggregate demand will continue to be the key disinflationary factor;
- In an environment of global economic crisis, the drop in GDP and the decline in employment in Serbia were moderate compare to those recorded in other countries – GDP fell 2.8% in 2009 and is expected to grow 1.5% in 2010;
- Investment spending and net exports will be the key drivers of economic recovery in 2010, while domestic consumption will continue declining, though to a lesser degree than in 2009;
- The weakening of the dinar in late 2009 and early 2010 is estimated to have been largely seasonally-induced;
- Inflation will move below the lower bound of the target tolerance band in H1 2010, and will retreat gradually to the target by end of year (6±2%);
- Key risks to the projection are the exchange rate pass through to inflation (short-term) and the speed of economic recovery (medium-term);
- The key policy rate is more likely to be lowered in the coming period than kept on hold (9.5%). However, the pace of lowering the key policy rate will be slower than in the prior period.

Highlights

Monetary policy since the November *Inflation Report*

Inflation

Economic activity and international relations

Financial markets

Inflation projection and monetary policy outlook

Monetary policy was more expansionary in Q4

Chart 2. **Monetary Conditions Index**

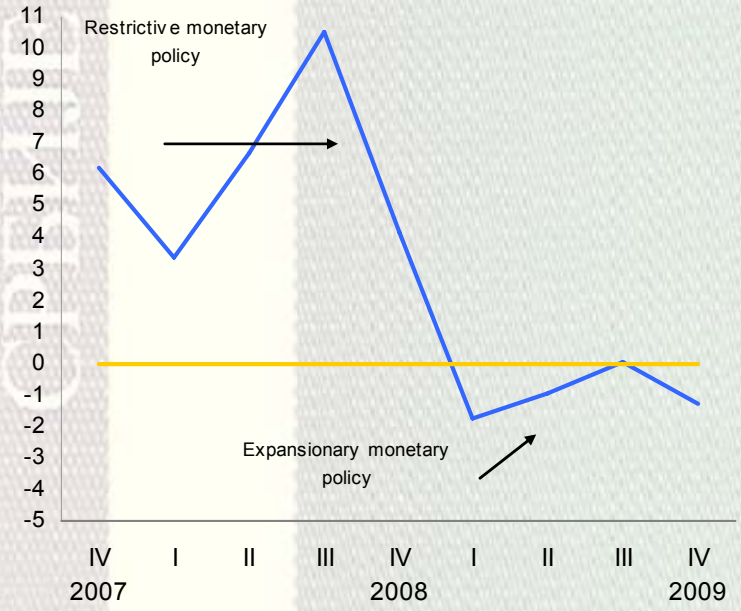
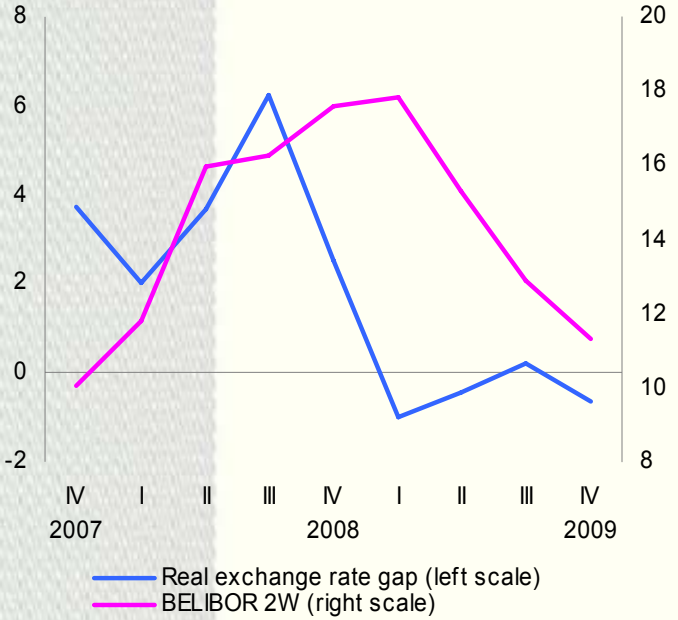


Chart 3. **BELIBOR and the real exchange rate gap** (in %)



- Key policy rate was cut by 250 basis points in Q4.
- Decisions on the level of the key policy rate were taken principally with a view to achieving the target inflation rate in H2 2010.
- Downward revisions of the key policy rate in Q4 were based primarily on the medium-term disinflationary effects generated by domestic demand.
- Q4 saw the opening of the depreciation gap of the real exchange rate, i.e. the real exchange rate depreciated and fell below the long-term trend.

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Q4 inflation growth was much lower than expected

Chart 4. **Annual inflation rates**
(in %)

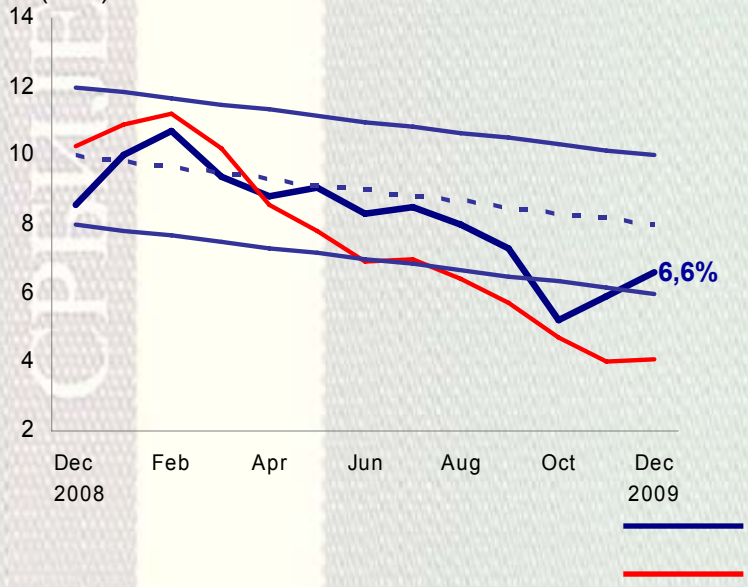
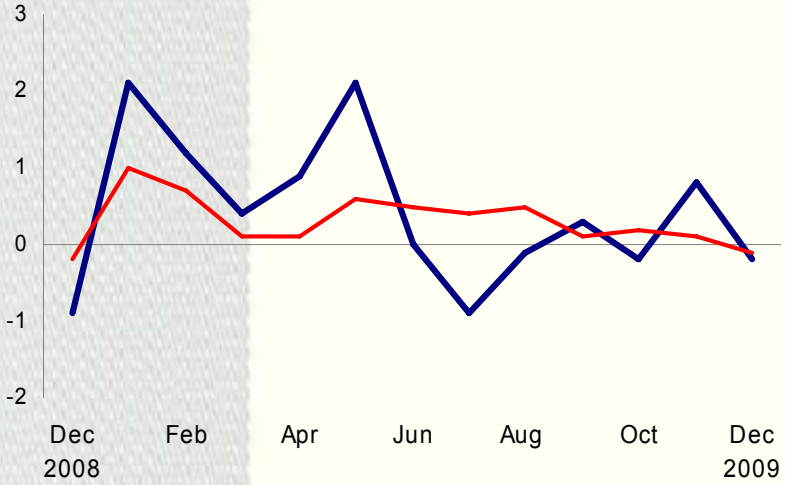


Chart 5. **Monthly inflation rates**
(in %)



- At end-2009, inflation measured 6.6% y-o-y, which is within the target range of 6-10%. Headline inflation outturn for 2009 was largely determined by regulated prices and core inflation (contributions of 3.9 pp and 2.8 pp, respectively).
- Q4 consumer price growth was rather low – 0.4%, owing to the declining prices of food and disinflationary effects of aggregate demand.
- What kept consumer price growth at a low level most was lower than expected growth in agricultural product prices (2.7%). Core inflation was 0.2%, and growth in regulated prices 0.5%.
- The slowdown in y-o-y growth in headline and core inflation continues – in January 2010 inflation measured 4.8%.

In Q1 2010 inflation will most probably undershoot the target

Chart 6. **Short-term inflation projection**
(y-o-y growth, y %)

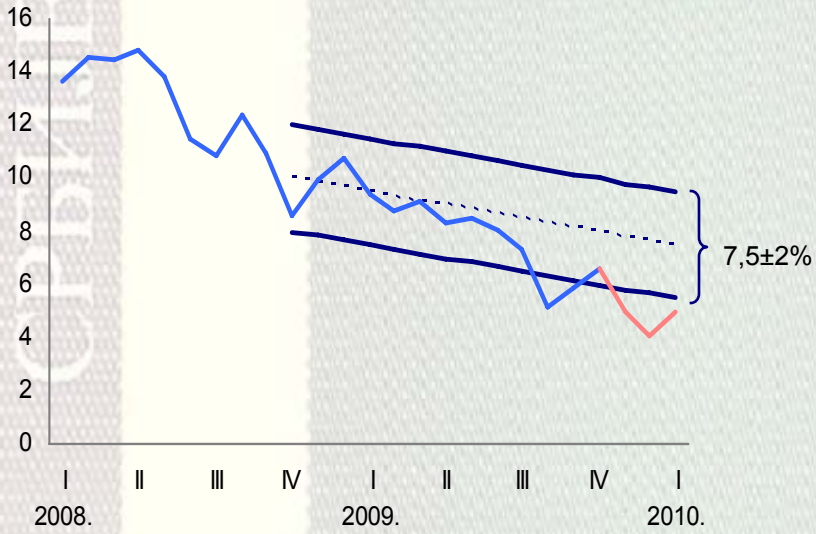


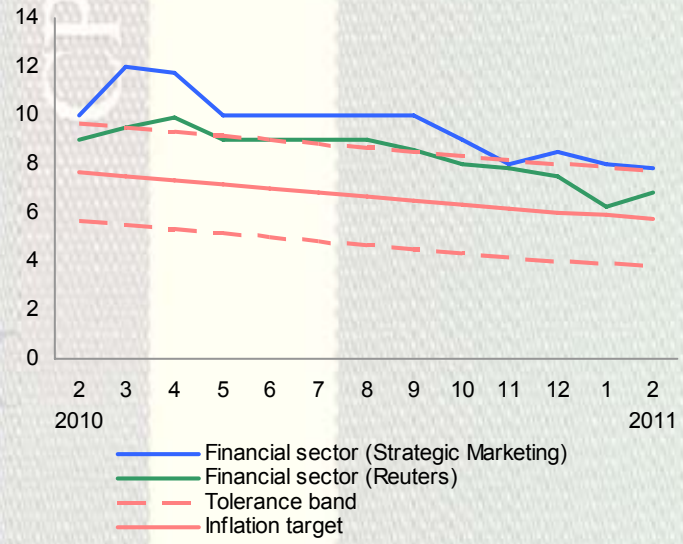
Table 1. **Major revisions of regulated prices expected in Q1**

	Growth rate (in %)	Contribution to retail price growth (pp)
Electricity	11.5	0.7
Cigarettes	12.2	0.5
Housing-utility services	5.3	0.2
Petroleum products	2.8	0.1

- Price growth is likely to reach around 2.2% in Q1 mainly on account of the expected regulated price growth of 5.9%.
- At end-March, y-o-y inflation will measure around 5.0%.
- The key risk to inflation projection relates to the extent to which producers and traders will pass through the effect of depreciation to end consumers in a low demand environment.

Inflation expectations edged down from the previous quarter

Chart 7. **One year-ahead expected and targeted inflation**
(in %, p.a.)



- **February *Reuters* survey:**
  - After their September-January decline, inflation expectations recorded a slight increase in February – the expected one year-ahead inflation is 6.9%;
- **February *Strategic Marketing* survey:**
  - One-year ahead inflation expectations of the financial sector are declining (currently 7.5%).

A year into fully fledged inflation targeting

- The first year of operating a fully fledged IT regime passed against the background of the global financial crisis;
- Nevertheless, inflation in Serbia was kept within the target range throughout 2009, save in October and November when the target was undershot;
- The registered drop in GDP and employment was moderate, especially in comparison to countries with any type of fixed exchange rate pegs;
- The floating exchange rate absorbed the shocks efficiently;
- Growth in prices under government regulation was slightly higher than planned (15.5%);
- Inflation expectations eased, but remained above the targeted inflation;
- Transparency in communication with the public.

Text box: A year into fully fledged inflation targeting – the NBS's objective for 2009 achieved

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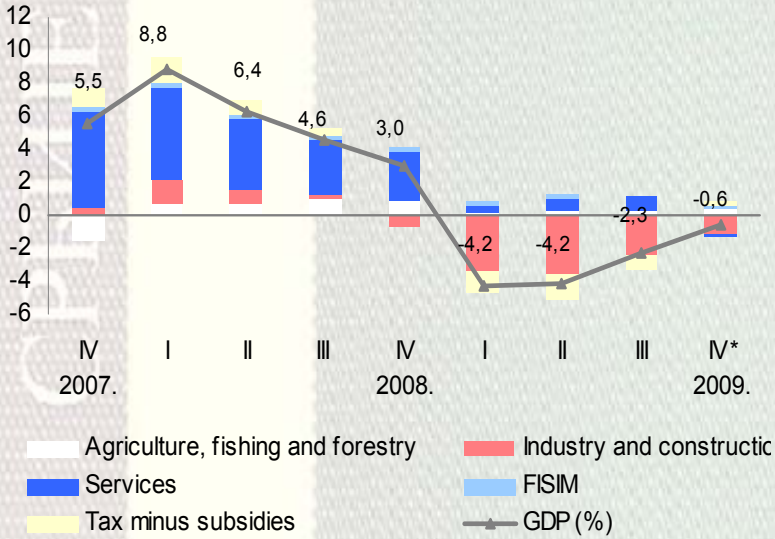
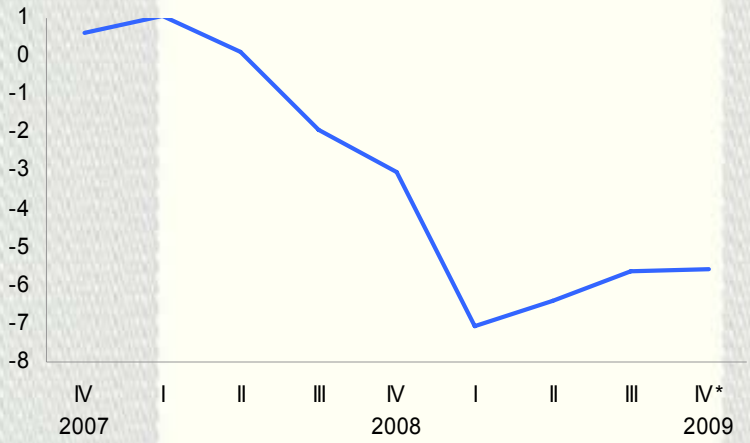
The recovery of economic activity slowed down in Q4, but so did the y-o-y decline in GDP

Chart 8. **Contributions to y-o-y GDP growth**
(in percentage points)



* NBS estimate.

Chart 9. **Output gap**
(percentual deviation from the trend)

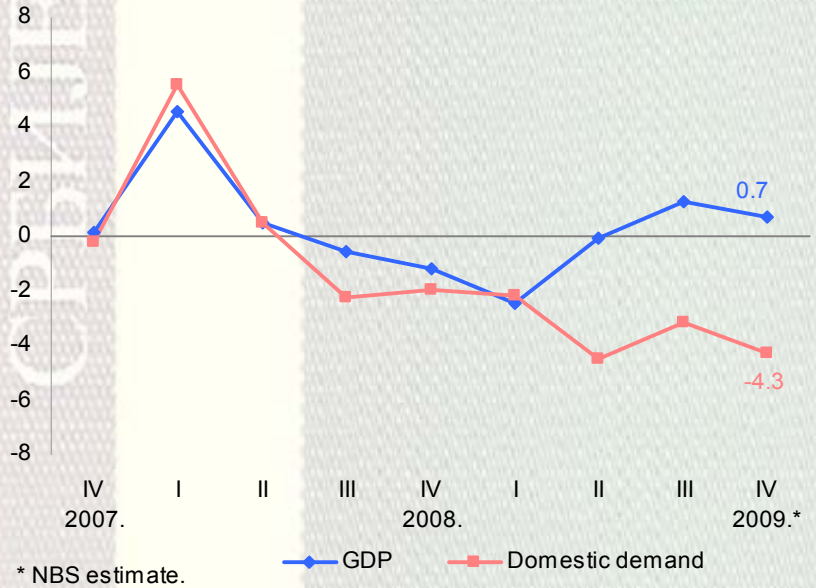


* NBS estimate.

- Economic growth in Q4 (0.7%) was slightly weaker than in Q3 due to subdued growth in industrial output, most notably that in the manufacturing industry. At the same time, y-o-y decline in GDP slowed down from -2.3% in Q3 to -0.6% in Q4.
- A 1.5% GDP growth is expected in 2010.

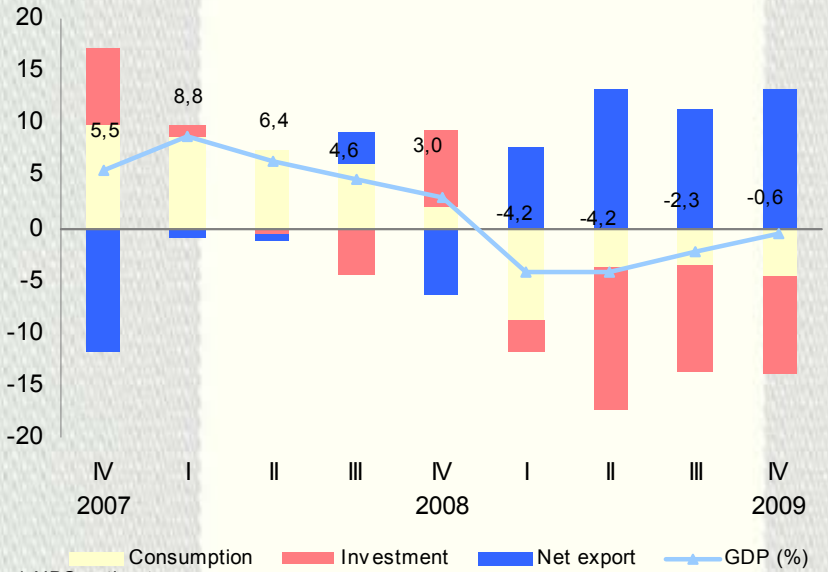
A decline in all domestic demand components continued…

Chart 10. **Growth in GDP and domestic demand**
(seasonally-adjusted quarterly growth rates)



* NBS estimate.

Chart 11. **Contribution to y-o-y GDP growth***
(in percentage points)

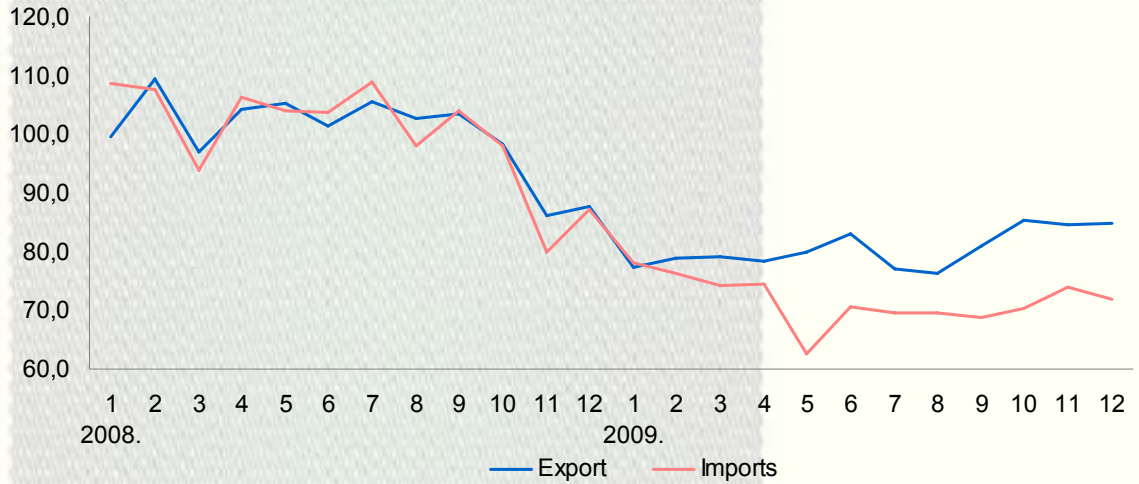


* NBS estimate.

- A y-o-y decline in real GDP in 2009 resulted mainly from a decline in investment activity and total final consumption. The effects of declining domestic demand on GDP (-14 p.p.) were partly offset by rising net exports (contribution of 13.4 p.p).
- In 2010, in addition to a pick-up in export demand, investment spending is likely to be the main driver of economic recovery. Household spending will contract further, but at a slower pace relative to 2009.

... but was partly offset by higher net exports

Chart 12. **Goods imports and exports**
(seasonally-adjusted data, 2008=100)



- Q4 current account deficit reached 5.8% of GDP, mainly on the back of contracted foreign trade deficit. Such a decline was induced by a sharper y-o-y decline in imports relative to exports of goods and services.
- Following a 24.6% y-o-y decline in Q3, exports of goods fell by only 6.7% y-o-y in Q4.
- Share of current account deficit in GDP stood at 5.7% over the whole 2009.
- In 2010, imports and exports are expected to rise by 2.5% and 6.0% y-o-y respectively, while the share of current account deficit is estimated at around 8% of GDP.

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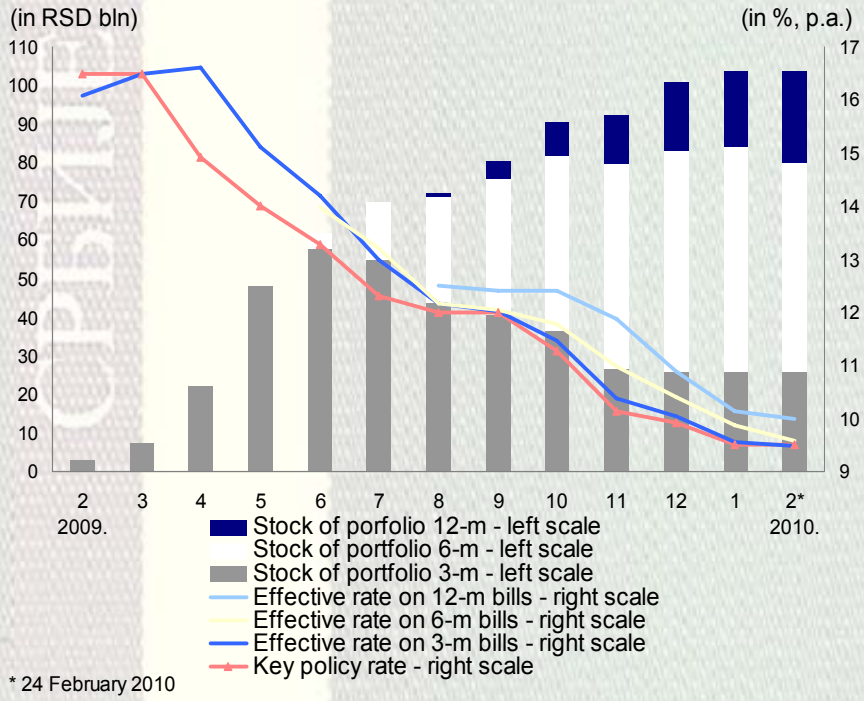
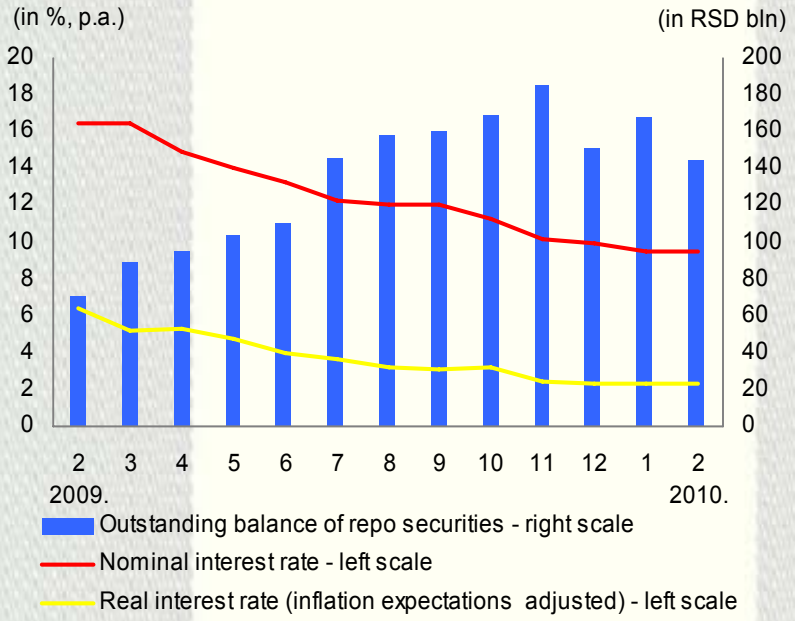
Despite further lowering of the key policy rate, bank investment was predominantly directed to securities

Chart 13. **Effective rates on T-bills and stock of portfolio**



* 24 February 2010

Chart 14. **NBS open market operations**



- Despite lowering of the key policy rate, investment in NBS bills in Q4 remained attractive to banks. The end-of-year slump in repo stock resulted from banks' seasonally higher need for liquidity.
- A rise in dinar liquidity was fuelled by changed FX component of allocated FX required reserves (from 70:30 to 80:20 for banks signatories to the Vienna Initiative).

Economic recovery was accompanied by recovery in the lending market

Chart 15. **Lending activity**
(quarterly growth rates, in %)

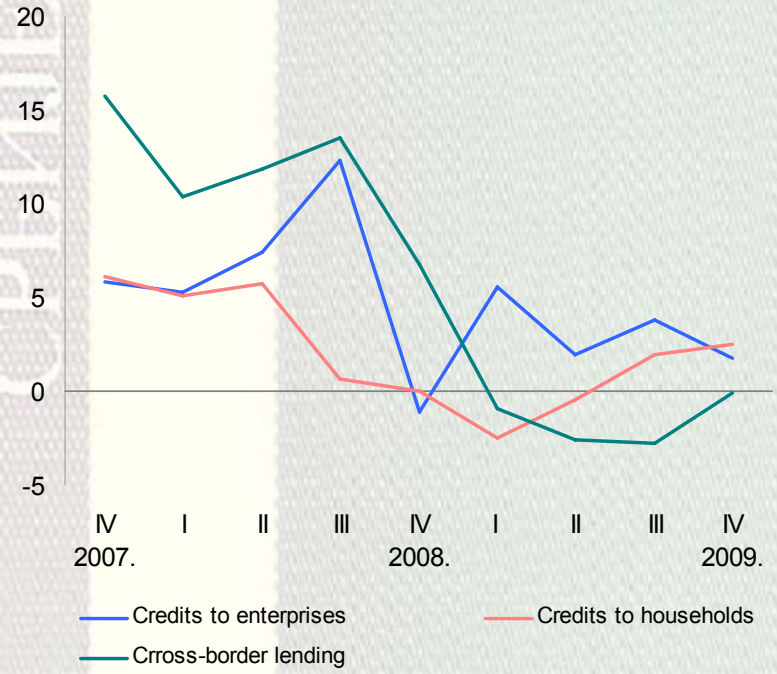
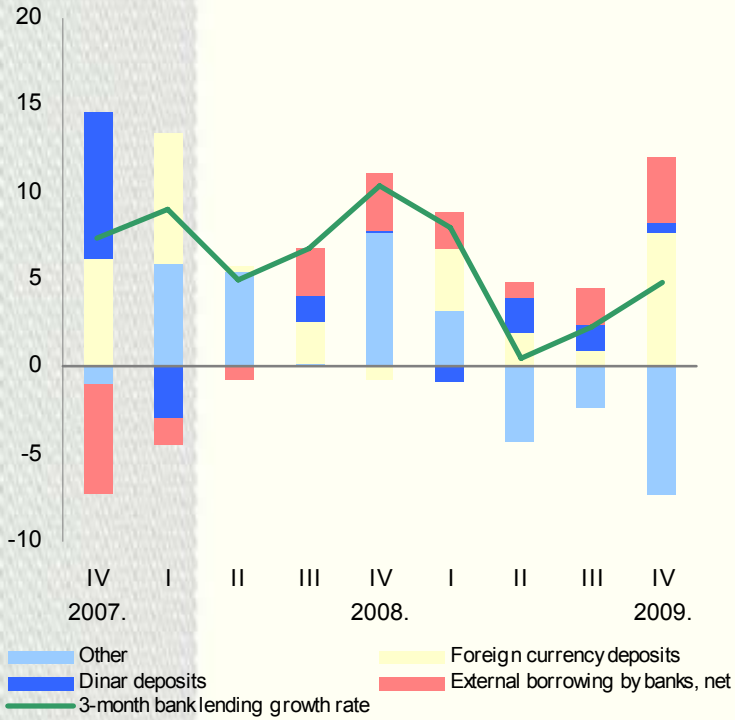


Chart 16. **Contribution to bank lending growth**
(in percentage points)



- Domestic lending rose by 2% in real terms (1.8% and 2.5% to corporate and household sectors respectively), while a y-o-y slowdown in lending came to a halt.
- Net repayment of foreign debt by enterprises continued.
- The subsidised segment of the market recorded somewhat less activity.

The upward trend in stock exchange indices ended

Chart 17. **BELEX 15**

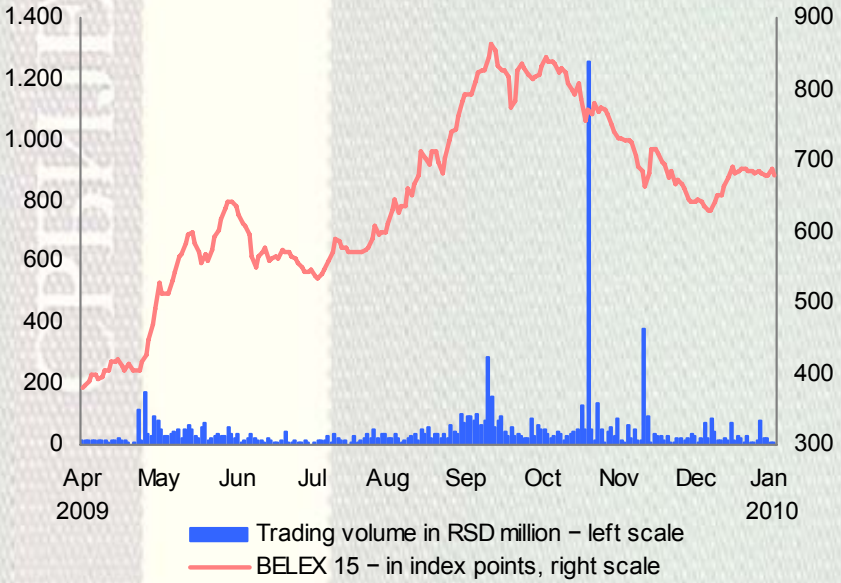
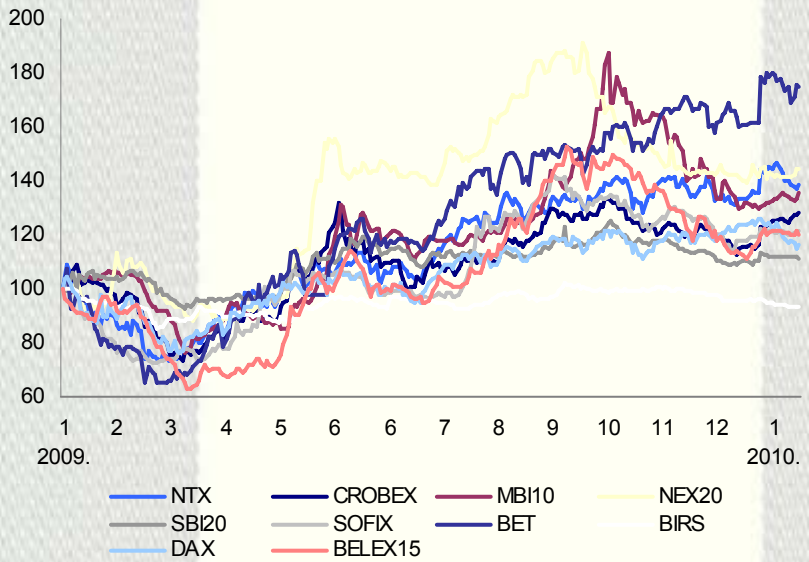


Chart 18. **Stock exchange indices across the region**
(in index points, normalised, 31.12.2008 = 100)



- Both indices on the Belgrade Stock Exchange edged down in Q4 only to stabilise in early 2010. Similar movements were recorded on stock exchanges across the region.

Depreciation pressures are in place since November

Chart 19. **IFEM turnover and exchange rate**

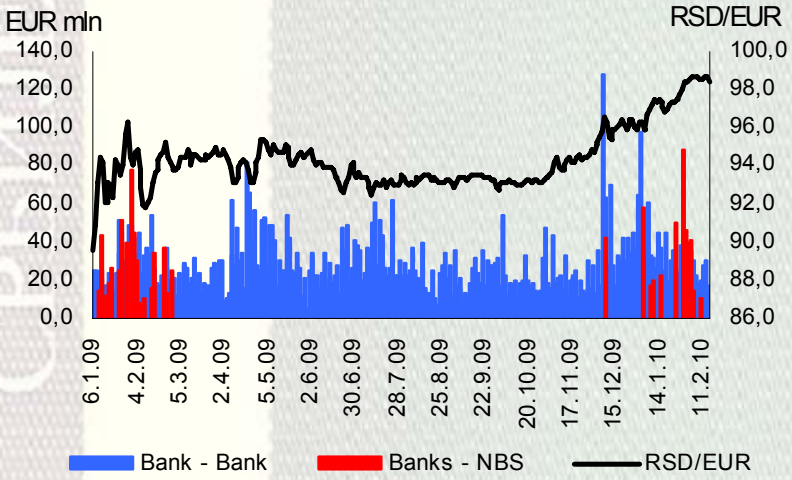
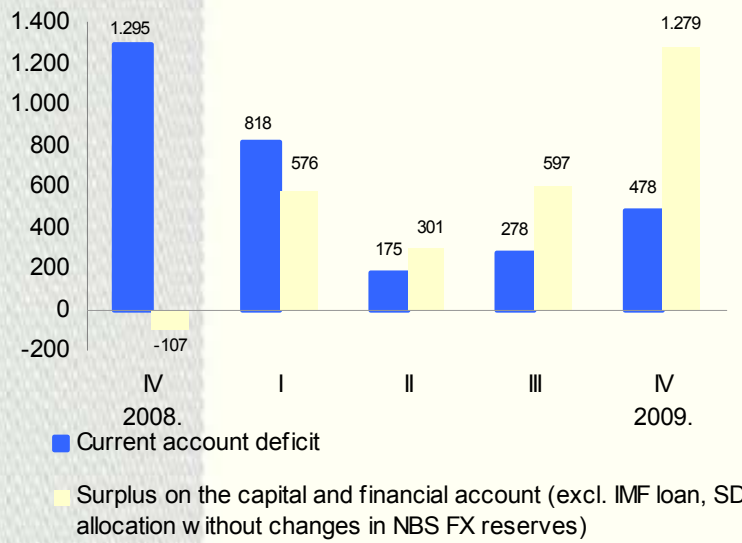


Chart 20. **Current account deficit and net capital inflow** (in EUR mln)



- Depreciation pressures were renewed by end-October. Since then, the dinar has depreciated by around 7% against the euro. Volatility of the exchange rate was weaker than in the last year despite smaller NBS interventions. From December until mid-February, ca. EUR 470 mln were sold to banks. NBS interventions were aimed at ensuring smooth operation of the forex market and pre-empting excessive fluctuations of the exchange rate.
- Average daily interbank turnover remained low (ca. EUR 30 mln).
- FX liquidity of the banking sector was comfortable, although banks were more inclined to keep ample FX liquidity.

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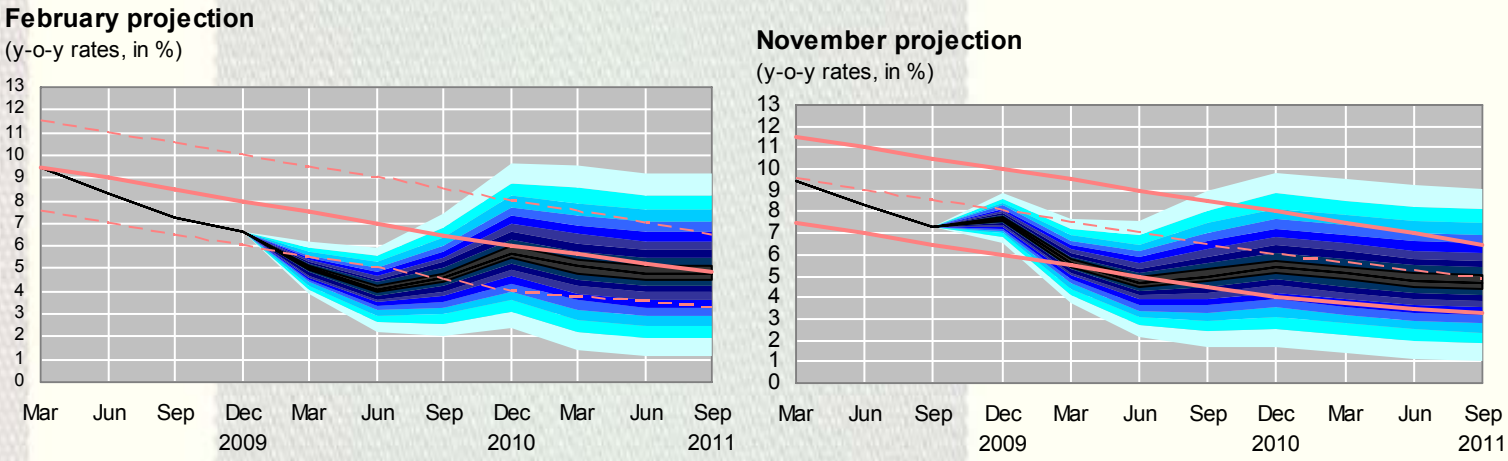
Inflation projection and monetary policy outlook

In the first three quarters of 2010, inflation is most likely to move around the lower bound of the target band only to trend closer to the target by the year-end

Chart 21. **Current vs. previous projection**



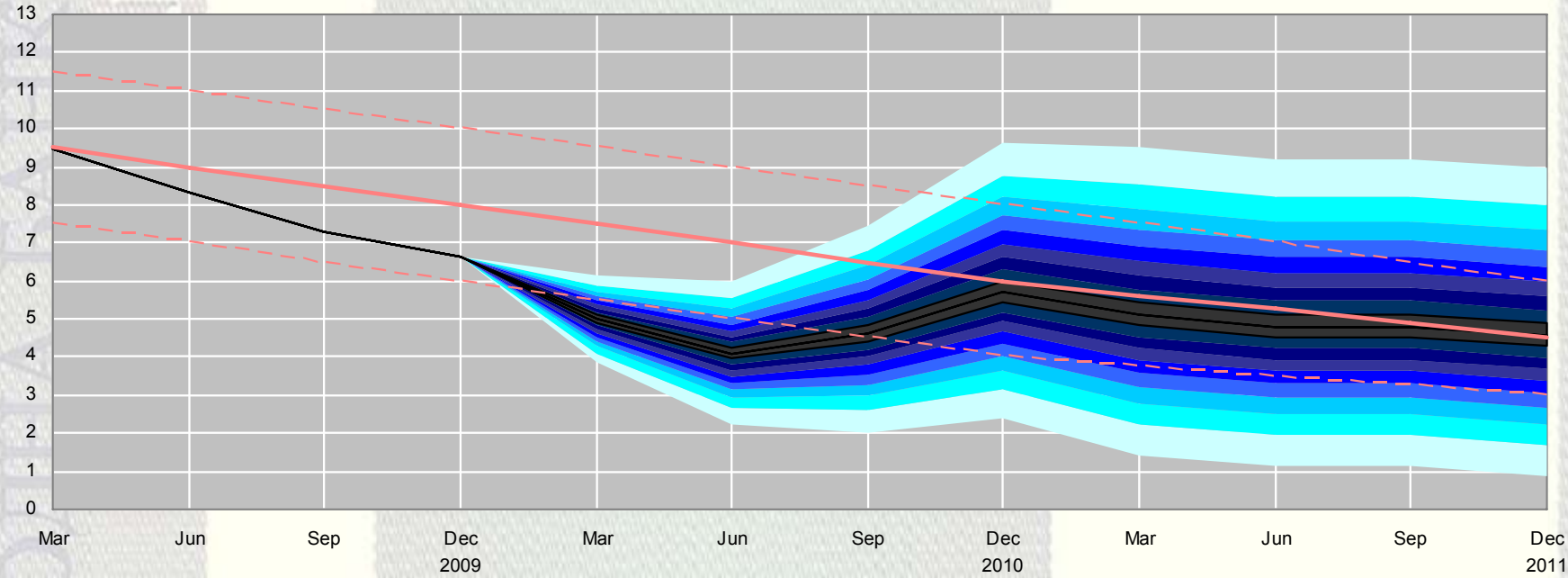
- February central inflation projection for H1 2010 is somewhat lower than the November one, while projection for the year-end is higher. The two projections for 2011 are more or less the same, as are the projection bands.
- Since Q3, the new projection band is mildly asymmetric to the upside mainly due to risks relating to the speed of economic recovery, possible growth in food prices and the exchange rate pass-through.

Key policy rate outlook

- Based on the current inflation projection and its underlying risks, the NBS Monetary Policy Committee judges that the key policy rate is more likely to be lowered in the coming period than kept on hold (9.5%).
- The pace of potential lowering of the key policy rate will be slower than in the prior period.
- Room for monetary relaxation still exists in light of:
  - continued low aggregate demand,
  - freeze on public sector wages and pensions.
- Lowering of the key policy rate may be temporarily halted in case of stronger-than-expected inflationary pressures coming from:
  - more rapid recovery of aggregate demand,
  - pass-through of sharper food price growth to overall price levels,
  - stronger effects of dinar's depreciation on inflation.

Inflation projection

Chart 22. **Inflation projection**
(y-o-y rates, in %)



- In January 2010, inflation measured 4.8% y-o-y.
- In H1 2010 inflation will most probably move below the lower bound of the target band, and trend closer to the target (6±2%) by year-end.
- In late 2010 and throughout 2011 inflation is expected to revolve around the target.

THANK YOU FOR YOUR ATTENTION!