Inflation Report – August 2010

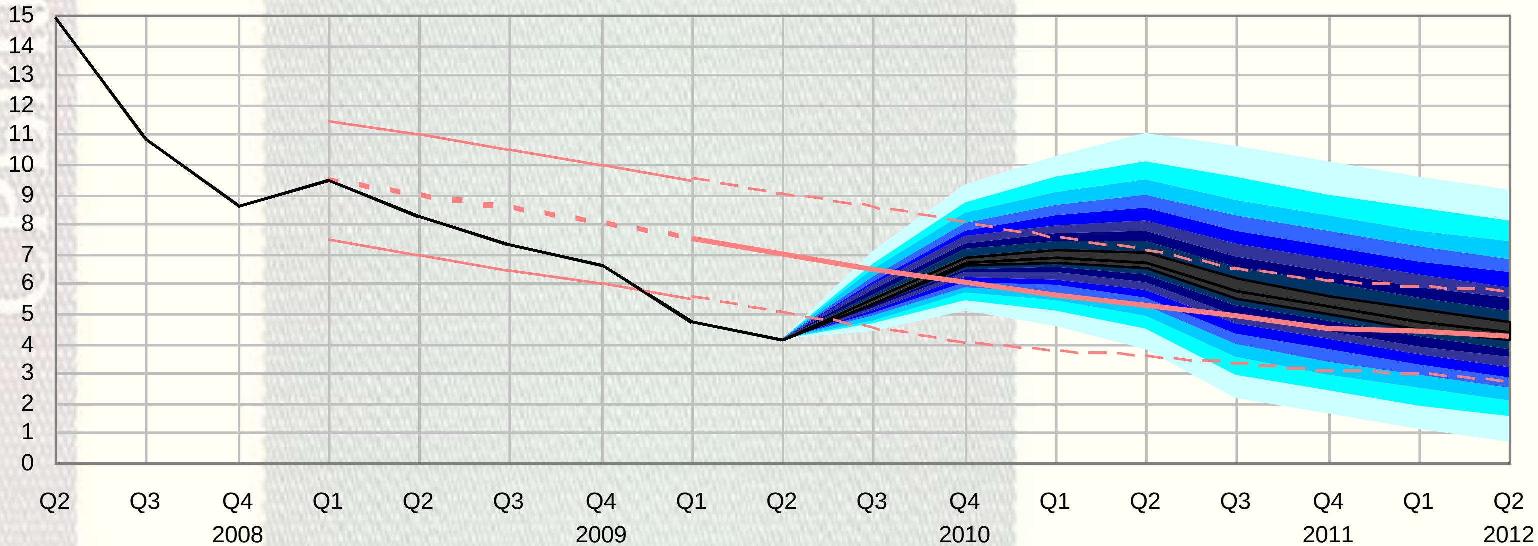
Belgrade, 11 August 2010

Key messages of the August *Inflation Report*

- Inflation y-o-y fell further in Q2 2010, and remained below the lower bound of the target tolerance band.
- Inflation q-o-q in Q2 was somewhat higher than in Q1 and measured 2.5% mostly due to the seasonal growth in agricultural product prices and the increase in petroleum product prices.
- Economic recovery continued in Q2 (1.8% y-o-y) at a somewhat brisker pace, largely owing to the increase in net exports. The contribution of domestic demand remained negative.
- Economic activity will recover moderately in the coming period – GDP growth in 2010 is estimated at around 1.5% and in 2011 at around 3.0%.
- External demand will continue to be the key driver of economic growth, and domestic demand is unlikely to revive significantly before 2011.
- Inflation is expected to return within the target tolerance band in Q3 2010.
- In mid-2011 inflation is expected to revolve around the upper bound of the target tolerance band, falling gradually back towards the target by year-end (4.5 ± 1.5%).
- The key risks to inflation projection are those relating to food prices, exchange rate pass-through to inflation, risk premium, premature growth in public sector wages and the speed of the eurozone economic recovery.
- Monetary policy should act to prevent the second-round effect from agricultural products to other prices as well as to inflation expectations.

Inflation projection

Chart 29. **Inflation projection**
(y-o-y rates, %)



- Inflation measured 4.2% in June 2010 and is estimated to have reached around 5% y-o-y in July.
- Y-o-y inflation will return within the target tolerance band in early Q3.
- In mid-2011 it is expected to revolve around the upper bound of the target tolerance band, gradually falling back towards the target, which for end-2011 is set at 4.5   1.5% and for end-2012 at 4   1.5%.

Highlights

Monetary policy since the May *Inflation Report*

Inflation

Economic activity and foreign trade

Financial markets

Inflation projection and monetary policy outlook

Monetary policy became more expansionary

Chart 2. **Monetary conditions index**

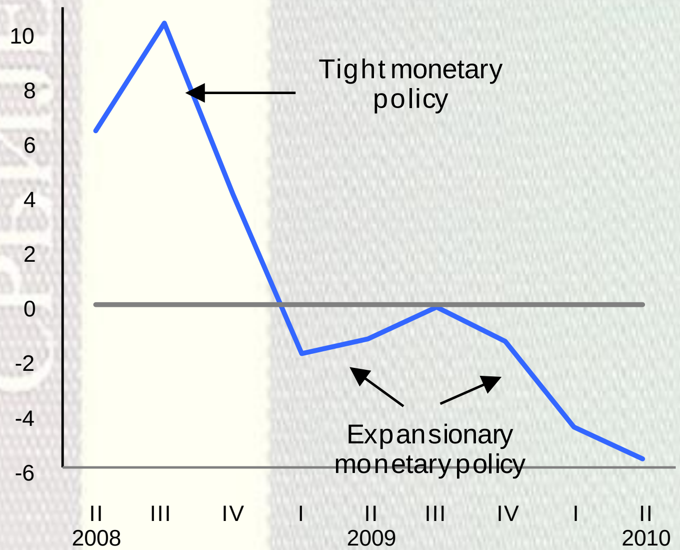
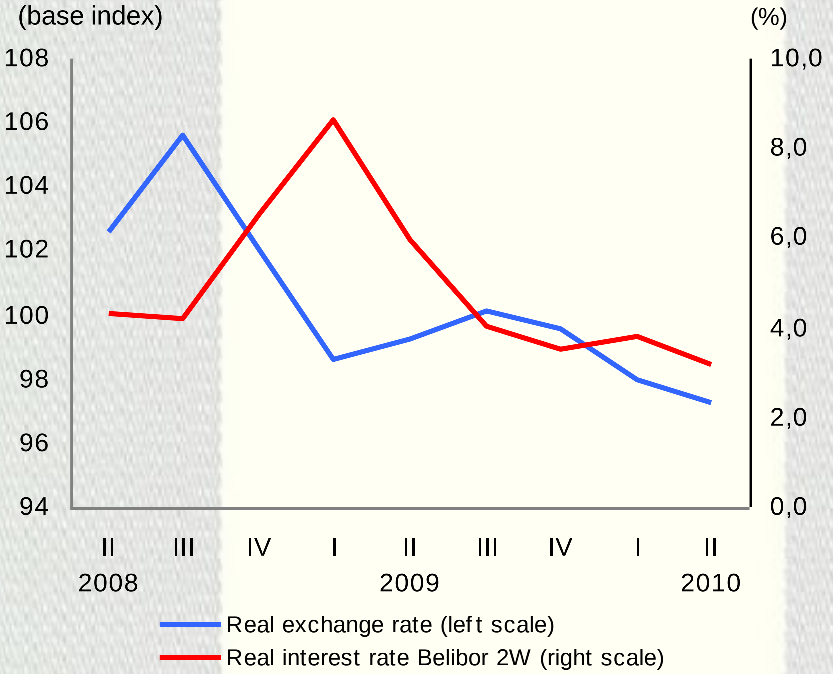


Chart 3. **Real interest rate Belibor 2W and real exchange rate**



- Further lowering of real money market interest rates and widening of the depreciation gap of the real exchange rate gave the monetary policy in Q2 an even more expansionary edge.
- Moreover, amendments to the decision on reserve requirements, that entered into force on 18 March (the effects of which will manifest throughout the year), led to a release of additional dinar liquidity.

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Q2 inflation was somewhat below the target tolerance band...

Chart 4. **Price movements**
(y-o-y growth, %)

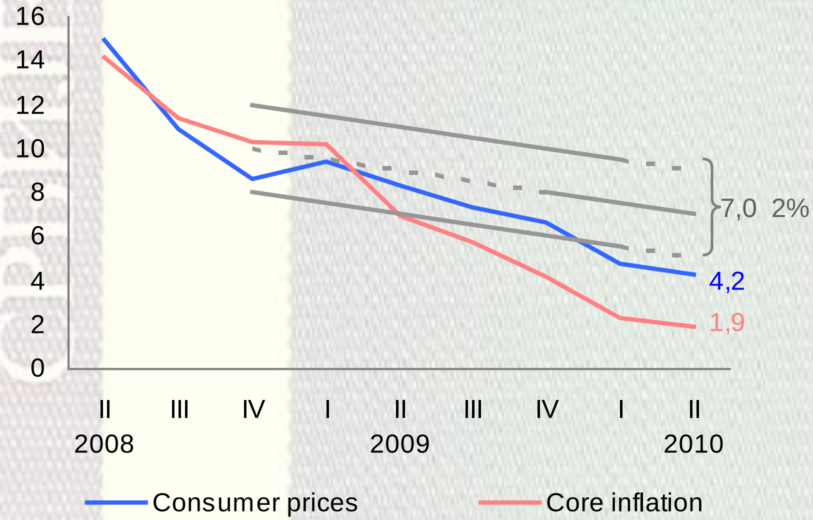
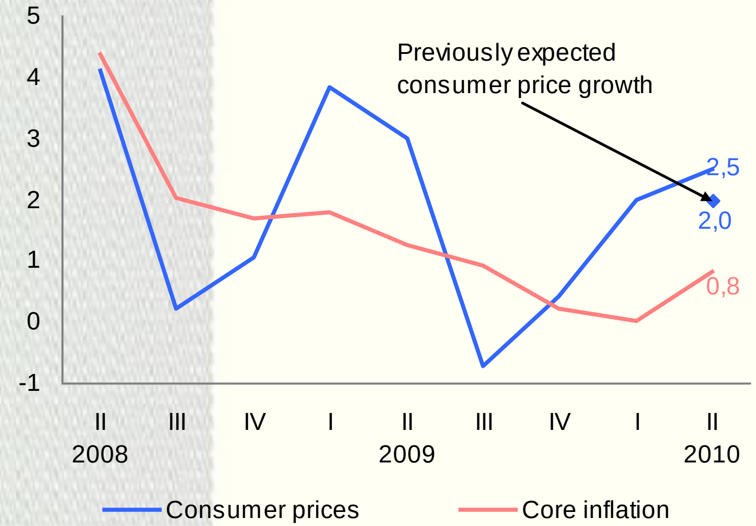


Chart 5. **Price movements**
(q-o-q growth, %)



- As the y-o-y growth in core inflation slowed down amid continued drop in food prices, inflation moved below the lower bound of the target six months in a row.
- Quarterly price growth was driven primarily by the rising agricultural product prices, and was slightly higher than anticipated at the time of the May *Inflation Report*.

Core inflation edged up...

Chart 6. **Core inflation by component**
(q-o-q growth, %)

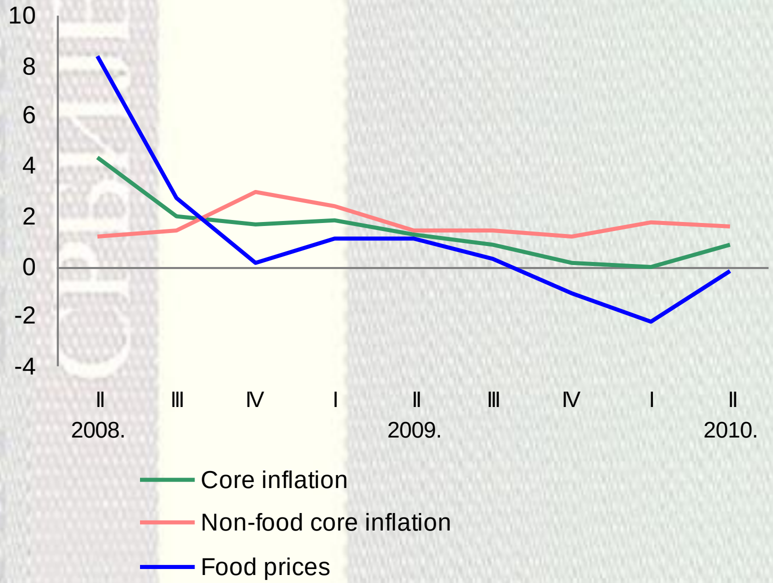
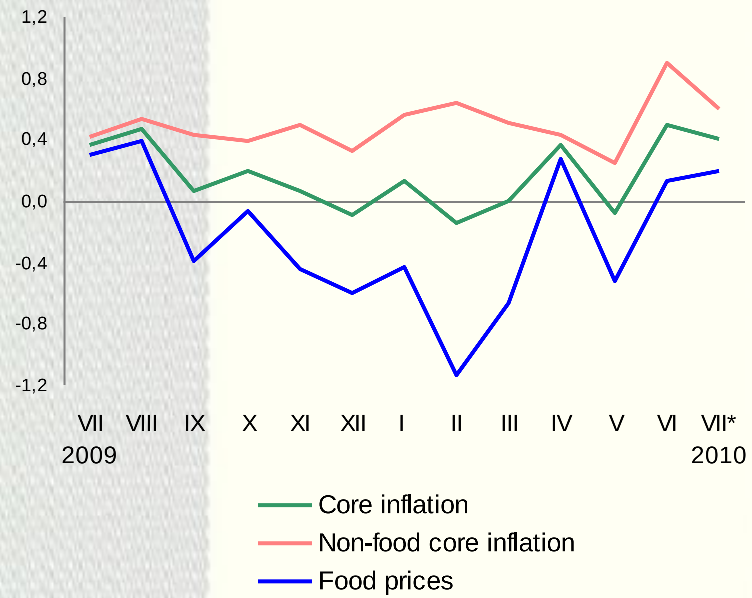


Chart 7. **Core inflation by component**
(m-o-m growth, %)

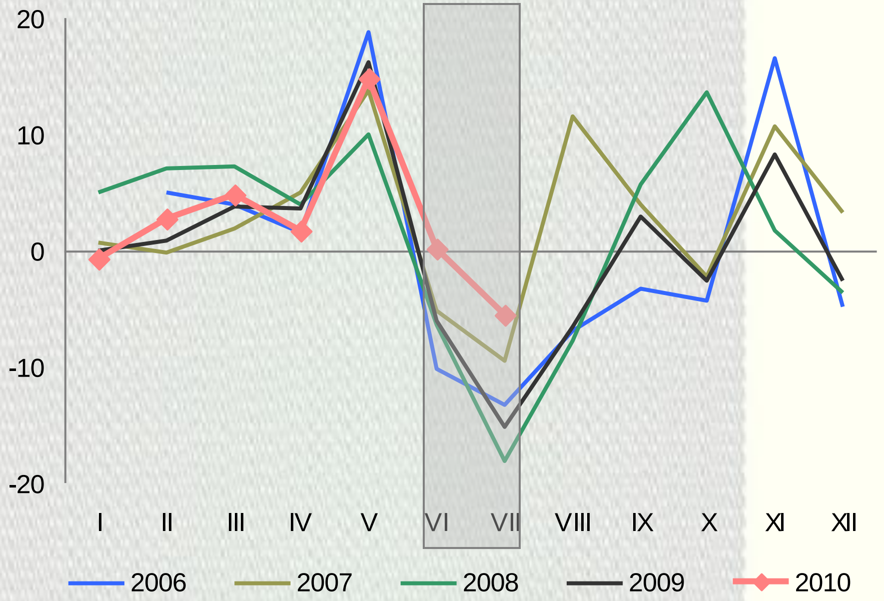


- Q2 saw the weakening of disinflationary effects of food prices (-0.1 pp contribution to core inflation).
- According to preliminary data, core inflation measured around 0.4% in July (0.1 pp contributed by food prices).

Text box: Comparative price levels for food in Serbia and countries in the region

...while the expected drop in agricultural product prices in June and July failed to materialise

Chart 8. **Agricultural product price movements**
(m-o-m growth, %)



- Due to poor weather and lower yields, the drop in agricultural product prices was lower than anticipated;
- In fact, the drop in agricultural product prices in June and July was the smallest in the last five years;
- Further movements in these prices will depend on late crop yields (corn, sunflower, sugar beet, etc).

Nature of agricultural shock: should the NBS react to this shock?

- Agricultural shock is a supply-side shock with a cost effect.
- Monetary policy should respond to agricultural shock in order to prevent the so-called second-round (pass-through) effect, i.e. to prevent the pass-through from agricultural product prices to other prices as well as to inflation expectations. This is one of the key reasons behind the August increase in the key policy rate – from 8% to 8.5%.
- Though the effects of agricultural shock are one-off, they automatically feed through into y-o-y inflation rates over a one-year horizon.
- Even with an average agricultural performance in 2011, we will see weaker inflationary pressures in the second half of 2011 because of the higher base.
- Possible monetary policy responses to agricultural shocks were discussed in earlier issues (Inflation Report – August 2007).

Inflation outlook for Q3

Chart 9. **Short-term inflation projection**
(y-o-y growth, %)

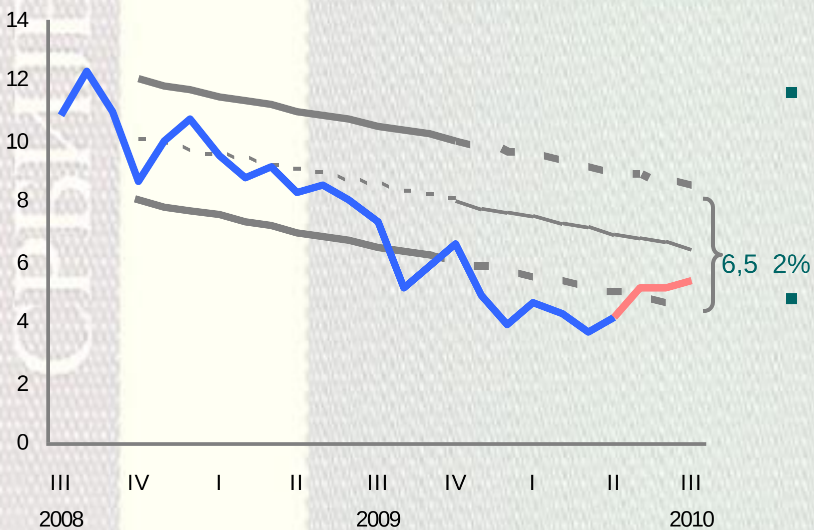


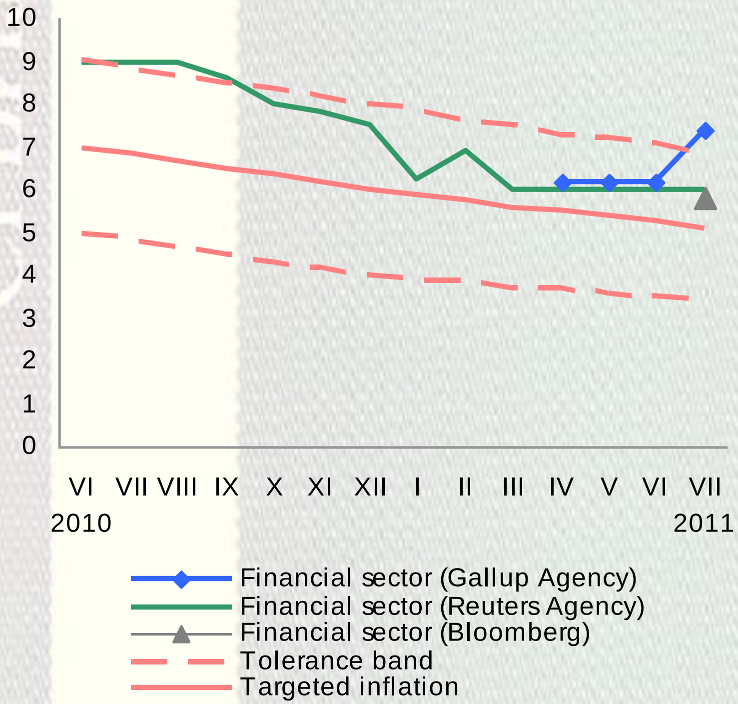
Table 1. **Major revisions of regulated pricesexpected in Q3**

	Growth rate (in %)	Contribution to consumer price growth (p.p.)
Utilities and housing services	6,1	0,2
Cigarettes	4.0	0.2
Medications	2.0	0,1

- Y-o-y CPI growth is expected to stay within the target tolerance band and settle at 5-6% in Q3.
- Agricultural product prices will be a key driver of inflation in the coming period, and the expected decline in these prices represents the main risk to inflation projection.
- In quarterly terms, prices will grow by around 0.5% due to:
  - a mild increase in market determined prices triggered by inflationary pressures from rising food prices and pass-through of dinar's depreciation to prices;
  - growth in regulated prices (0.5 pp contribution), and
  - negative contribution (1.1 pp) of agricultural product prices due to expected seasonal decline.

Inflation expectations were stable in Q2, but edged up in July

Chart 10. **One-year ahead expected and targeted inflation** (in %)



- According to the Reuters survey, inflation expectations of the financial sector have been stable since March (6%)
- According to Bloomberg, though slightly lowered (5.8%), inflation expectations remained stable in July
- However, the Medium Gallup agency shows that one-year ahead financial sector expectations have risen (7.4%) and are now slightly above the upper bound of the target tolerance band for July 2011.

Highlights

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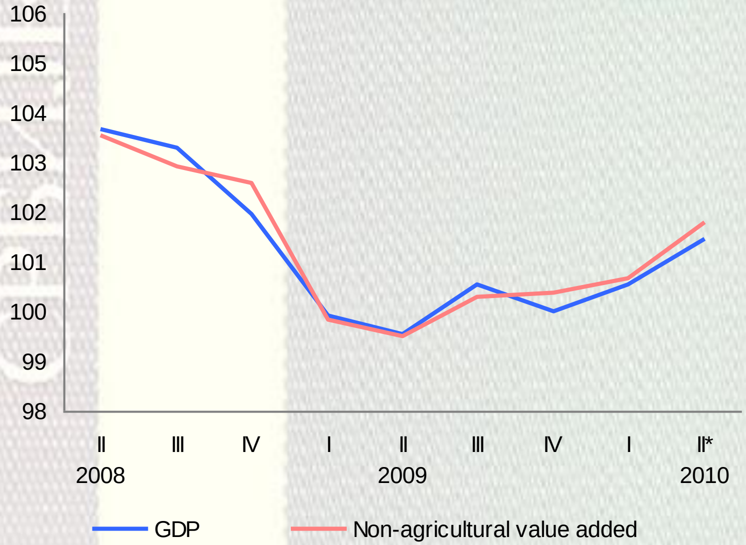
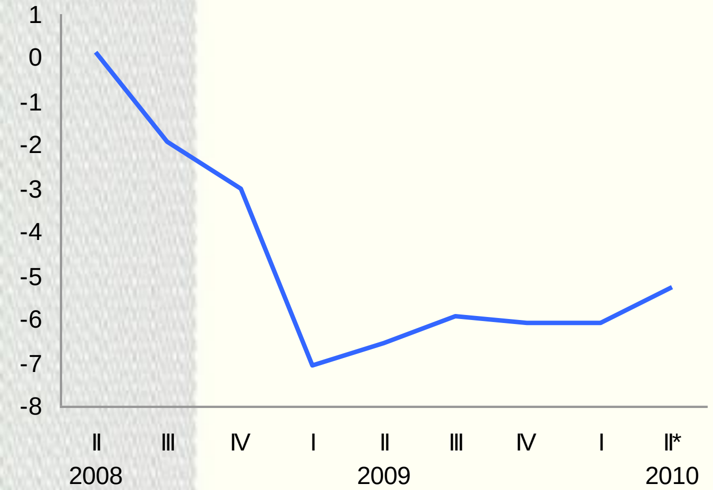
Economic recovery continues…

Chart 11. **Economic activity indicators**
(seasonally-adjusted data, 2009=100)



* NBS estimate

Chart 12. **Output gap**
(percentual deviation from the trend)

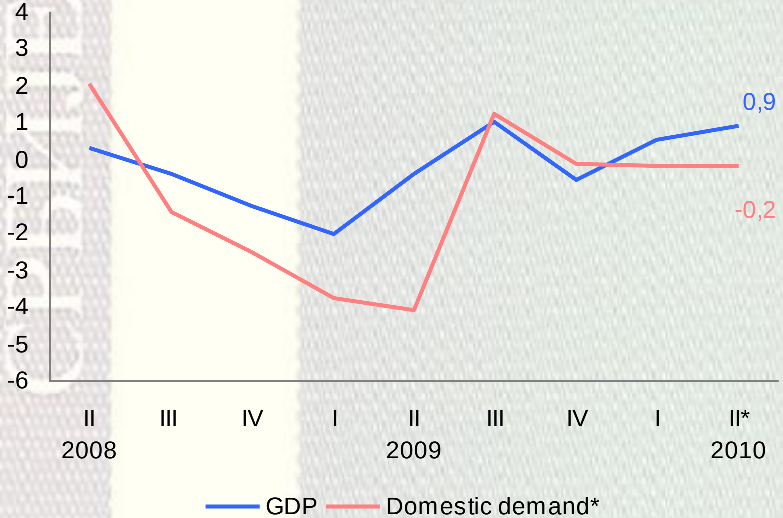


* NBS estimate

- According to our estimates, GDP growth in Q2 was 1.8% y-o-y or 0.9% relative to Q1. The Statistical Office released a preliminary estimate of 1.6% y-o-y.
- GDP growth is primarily due to the increase in industrial production (6.8% y-o-y).
- Negative output gap narrowed.

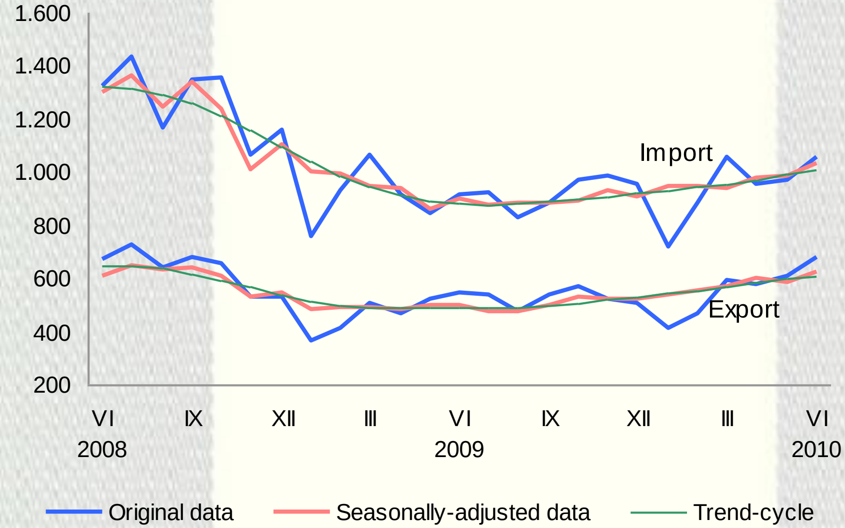
…mainly due to the growth in export demand

Chart 13. **Growth in GDP and domestic demand**
(seasonally-adjusted quarterly growth rates)



* NBS estimate

Chart 14. **Export and import**
(in mln EUR)

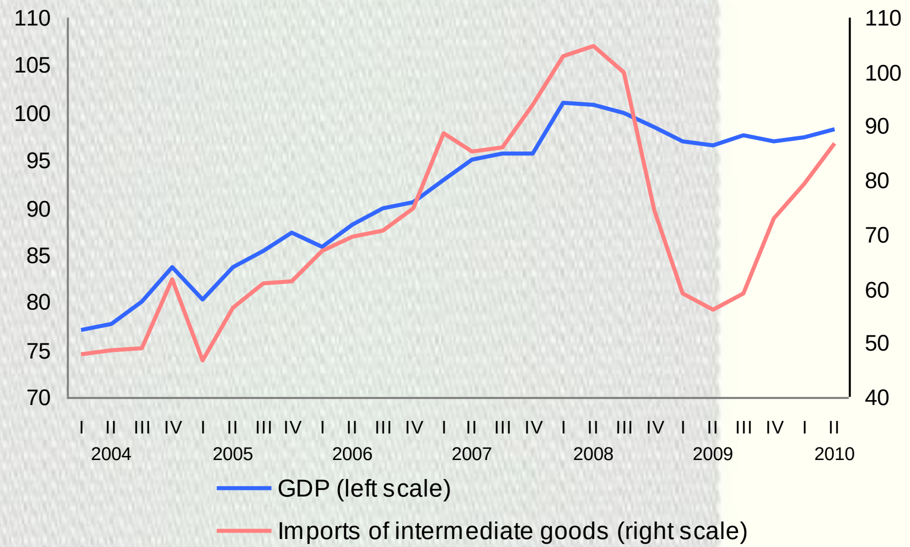


- Key contributors to GDP growth in Q2 were net exports (1.1 pp), private investment (0.8 pp) and household consumption (0.7 pp). Public investment and government consumption were on a steep decline and made negative contributions.

- As the growth in exports (21.6% y-o-y) was much stronger than in imports (11.3% y-o-y), the trade deficit contracted by 2.6% y-o-y.

The structure of imports improved

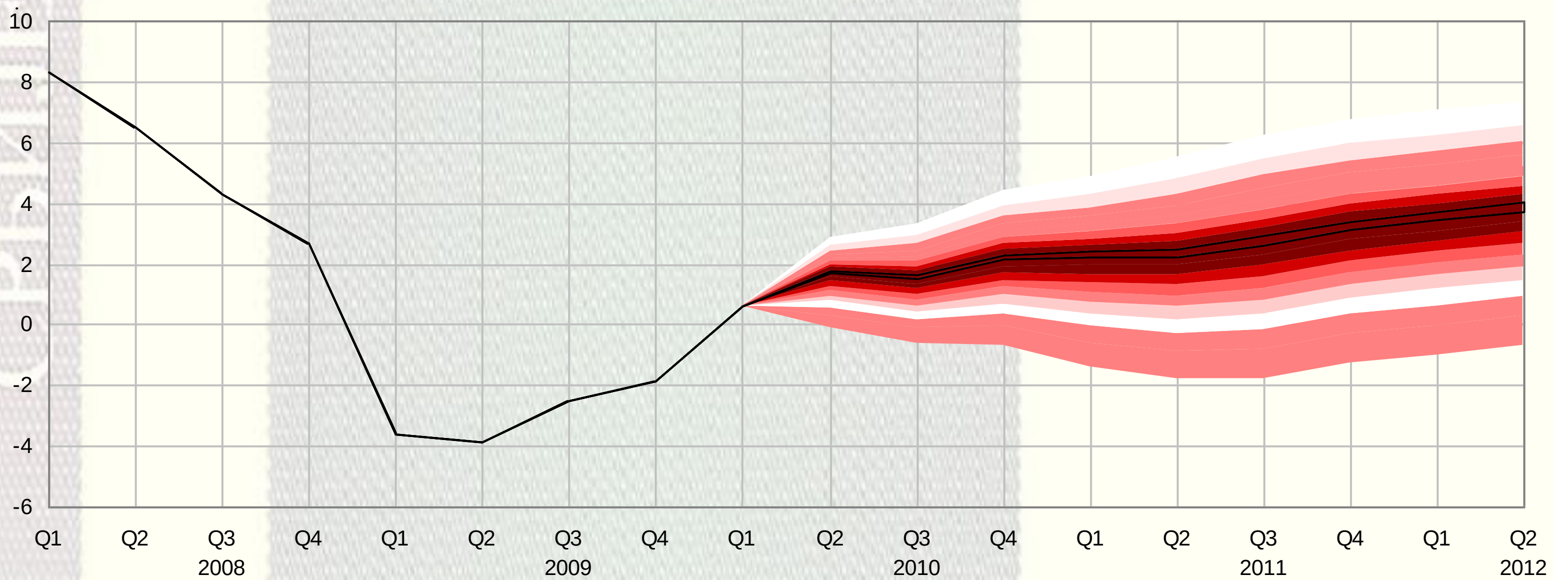
Chart 15. **GDP and import of intermediate goods**
(Q3 2008=100)



- After declining at the onset of the crisis, imports of intermediate goods have been on a steady increase since end-2009. In Q2 2010, their growth measured 34.4% y-o-y.
- Based on this, one can expect an increase in production over the coming period.
- On the other hand, imports of consumer goods continue to fall (-3.3% y-o-y), reflecting still low consumer demand.

Economic activity is poised for modest growth in the coming period

Chart 16. **GDP growth projection**
(y-o-y growth, %)



- Due to low domestic demand (contribution to GDP growth of -0,8 pp), economic recovery in 2010 will be relatively slow (1.5%). Net exports (1.3 pp) and investments (1.0 pp) will give a positive contribution to GDP growth.
- In 2011 domestic demand is expected to recover and prop up GDP growth (around 3.0%).
- GDP projection is asymmetric to the downside due to a possibly slower recovery in the eurozone induced by restrictive fiscal policy measures, as well as risks of a larger than expected fall in agricultural output.

Bank lending accelerated in Q2

Chart 17. **Bank lending activity**
(quarterly real growth rates, %)

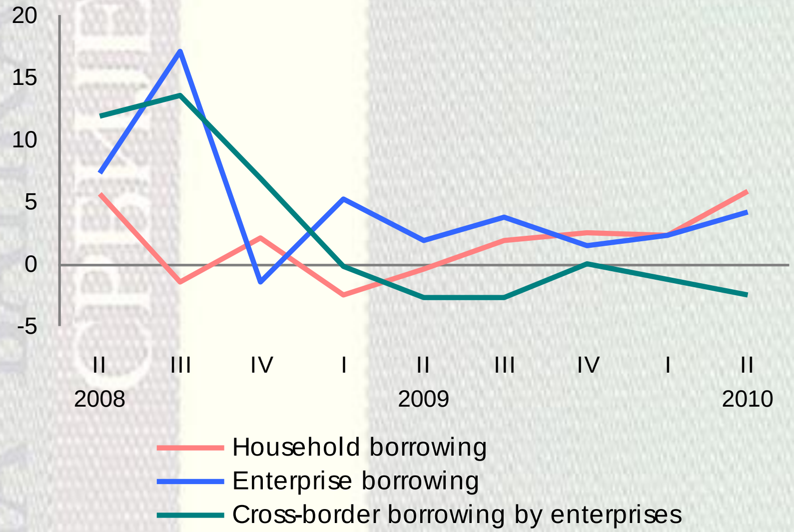
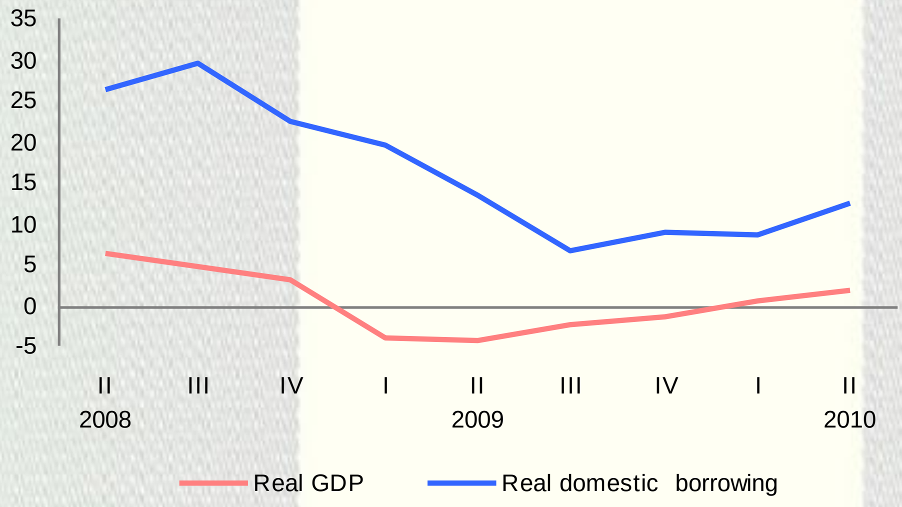


Chart 18. **Real domestic borrowing and real GDP**
(y-o-y growth rates, %)



- Real growth in domestic lending doubled in Q1 to reach 4.7% (corporates - 4.1%, households - 5.8%).
- An upturn in investment loans (RSD 37.6 bln) signals heightened private investment activity.
- The subsidised segment of the market continues to provide a strong impetus to growth in domestic lending. In the year to date, banks have extended around RSD 114 bln in subsidised loans, of which around RSD 23 bln in July alone. Starting from May, subsidised liquidity and consumer loans are extended in dinars only.
- The share of FX currency-linked loans was reduced (from 75% in March to 73% in June). The share of dinar non-indexed loans in new lending overshot 40%.

Wages and fiscal developments

Chart 19. **Average net wages – total and the public sector**
(seasonally-adjusted data, quarterly growth, %)

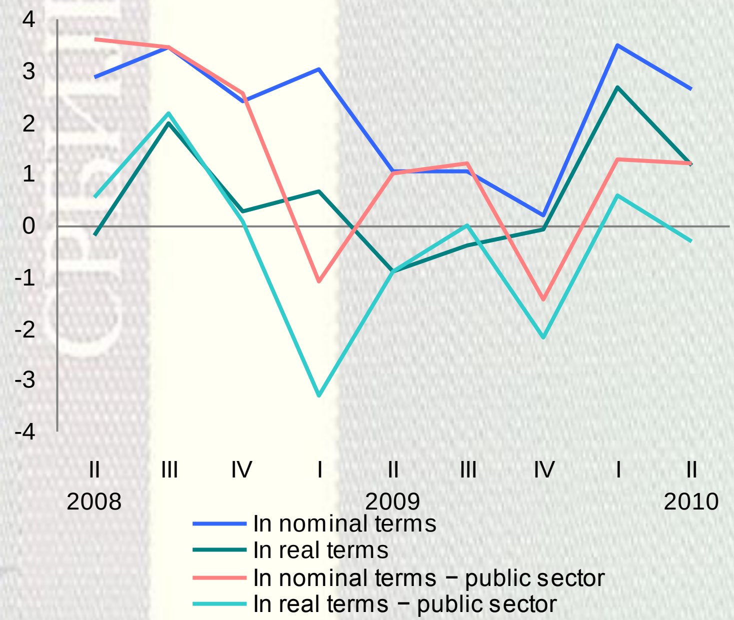
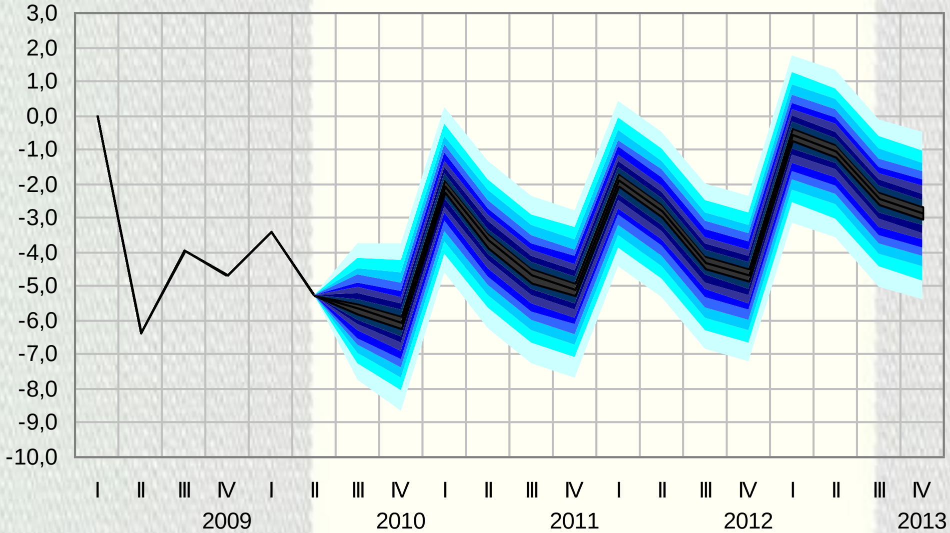


Chart 20. **Projected consolidated deficit**
(% of GDP)



- Q2 saw deceleration in private and public sector wage growth. Wages in the private sector are still rising faster than in the public sector.
- Consolidated budget deficit came at RSD 28.8 bln in Q2, but fiscal policy did not have an expansionary character (monetary effect of not more than RSD 2.5 bln).
- The deficit in the coming period will be lower than in 2009 and 2010.

Boxes: Fiscal policy in the medium run; Labour Force Survey

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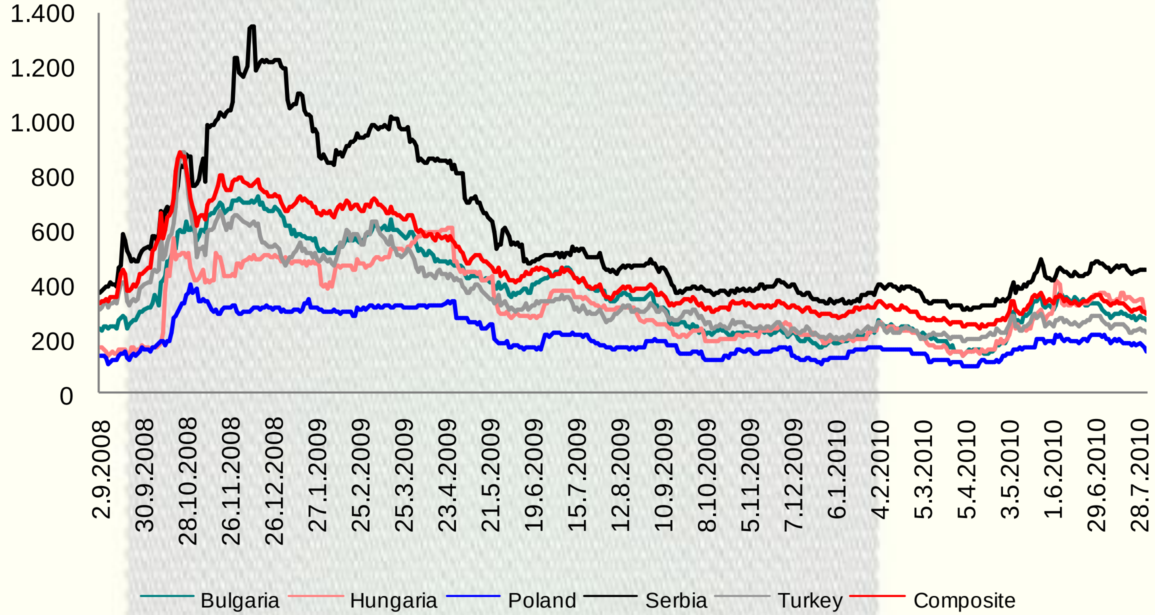
Risk premium rose further and remained high…

Chart 21. **Risk premium indicator – EMBI, by country**
(in basis points)



- The risk premium soared across the region in May and June, Serbia being no exception.
- Since mid-July, the risk premium has been winding down.

... leading to a hike in money market interest rates….

Chart 22. **Yield curve in the interbank money market**
(end of period, %, p.a.)

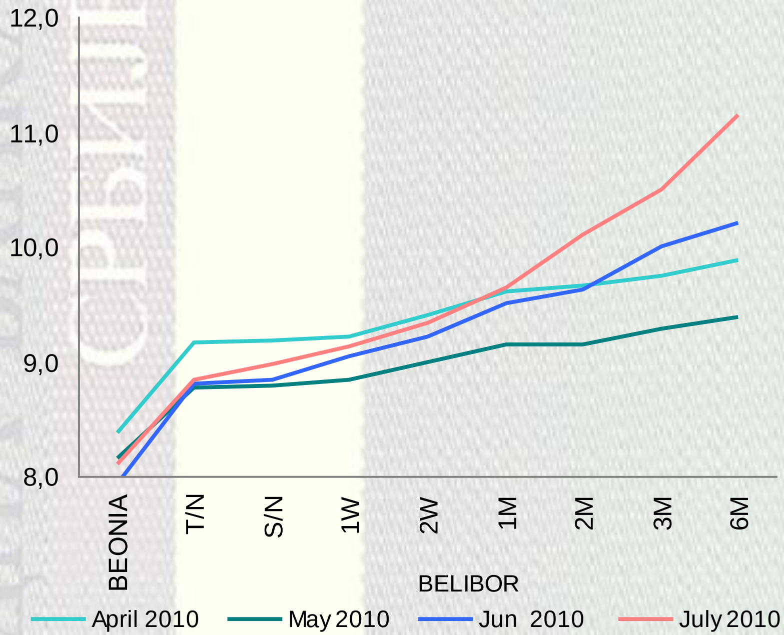
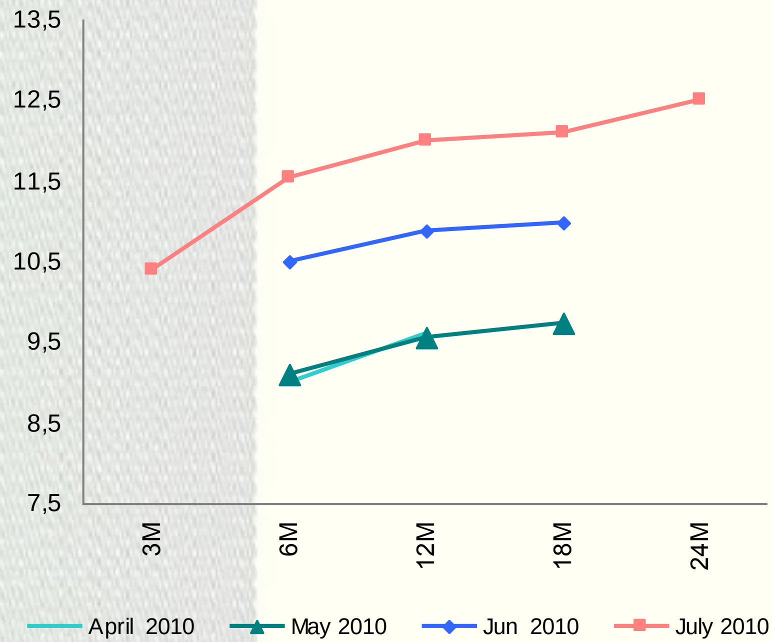


Chart 23. **Yield curve on securities**
(end of period, %, p.a.)



- Three- and six-month interest rates recorded a substantial rise in the interbank money market.
- Effective rates on T-bills have been rising since May. Despite this, bills were not sold out at the majority of auctions, which points to strong growth in risk premium or expectations of higher interest rates in the future.

Box: Expected interest rate movements in the European interbank market

... and movements in the dinar exchange rate

Chart 24. **IFEM turnover and exchange rate**
(in EUR bln) (EUR/RSD)

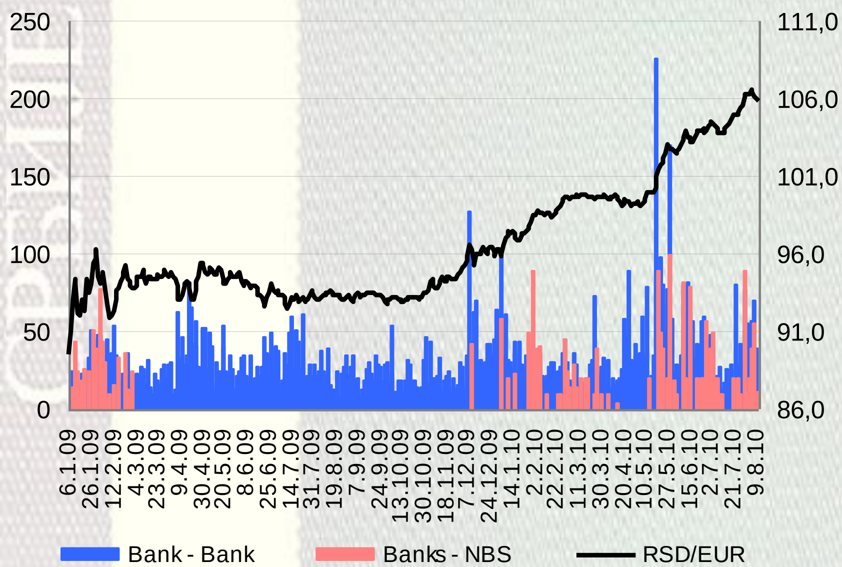
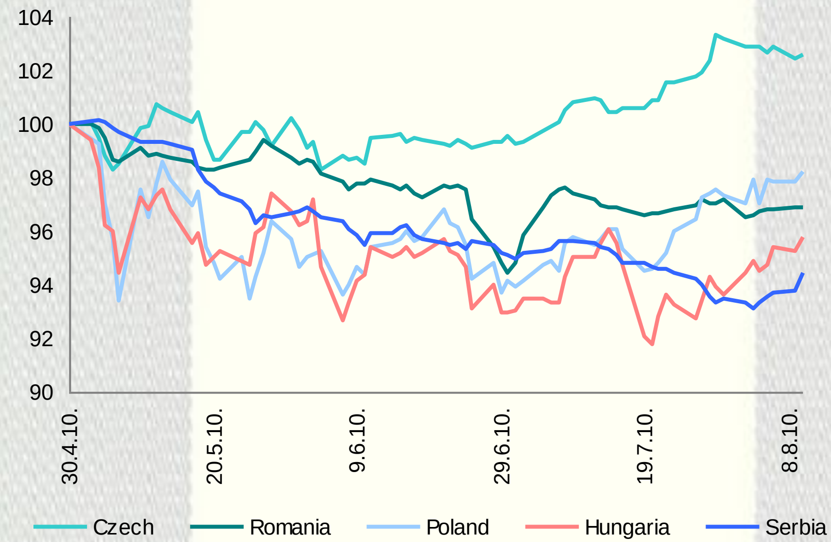


Chart 25. **Movements in exchange rates of some national currencies**
(30/04/2010.=100)



- The dinar continued to weaken in Q2.
- Depreciation pressures intensified in May – despite NBS's interventions, the dinar lost 5% in May and June. In the course of Q2, the NBS sold to banks EUR 785 mln (plus EUR 327 mln until 3 August).
- Dinar's depreciation in May and June was driven by regional factors (higher investor risk aversion), due to uncertainty about public finance sustainability in some countries.
- Over the past three weeks, the weakening of currencies of other countries with flexible exchange rates came to a halt. The dinar has displayed the same tendency over the last week.

Foreign capital inflow remains weak

Chart 26. **Structure of financial balance sheet**
(in EUR mln)

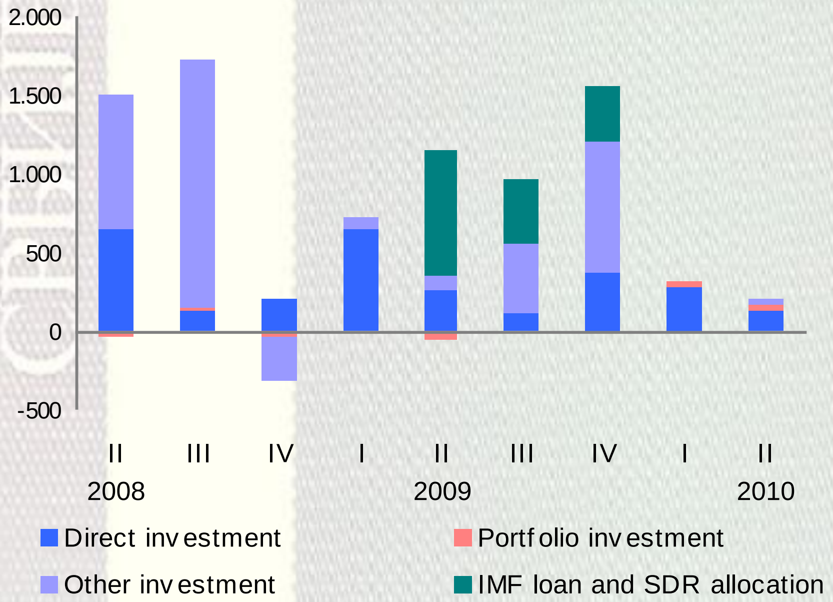
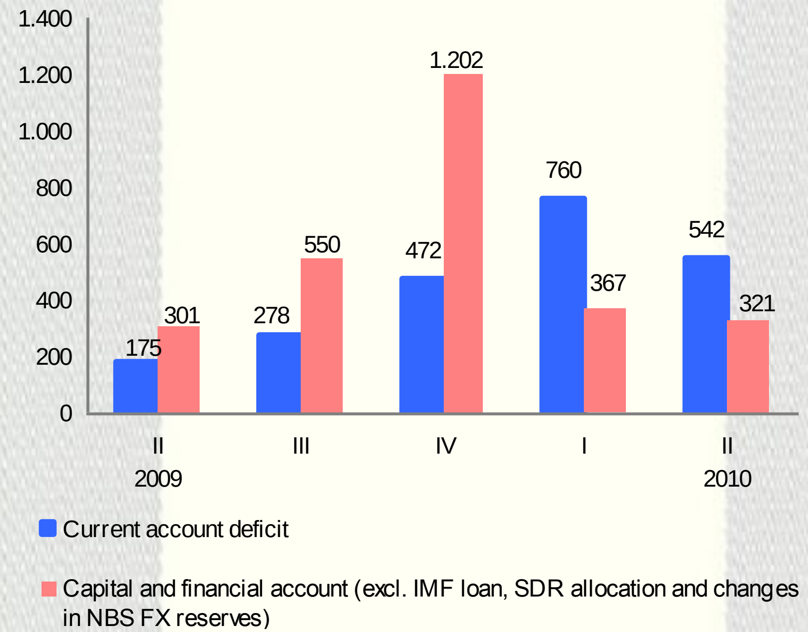


Chart 27. **Current account deficit and net capital inflow**
(in EUR mln)



- In Q2, FDI inflow was rather modest – EUR 136 mln. Banks and enterprises repaid their external debt by EUR 401 and 315 mln respectively.
- Half of the third tranche of the IMF loan was drawn in April, while 15% of the fourth tranche was drawn in June (total EUR 236 mln). The NBS can therefore draw additional EUR 507.2 mln – the major portion of this amount is available at any moment.

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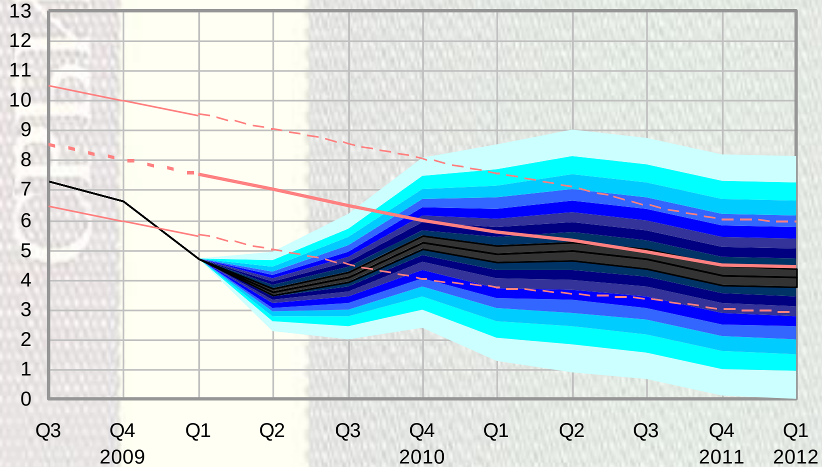
Projection assumptions

- Regulated prices will most probably move somewhat above the planned growth range of 9 ± 2% for 2010 (our estimate: 11.5%). They are planned to rise by 7 ± 2% in 2011.
- Due to their currently low level, agricultural prices are expected to rise more rapidly than other prices in the medium run.
- The gradual subsiding of the crisis is likely to result in a step-up in dinar’s real appreciation against the euro.
- Following risk premium growth in May and June, we expect a gradual return to a lower level, which will, along with the rise in the appreciation trend, induce a gradual decline in the real interest rate trend.
- External assumptions:
  - Despite restrictive fiscal measures in eurozone members, the eurozone economic activity is poised for recovery in the coming period as well;
  - The ECB is not expected to raise its policy rate before mid-2011;
  - World oil prices are likely to rise moderately in step with global economic recovery.

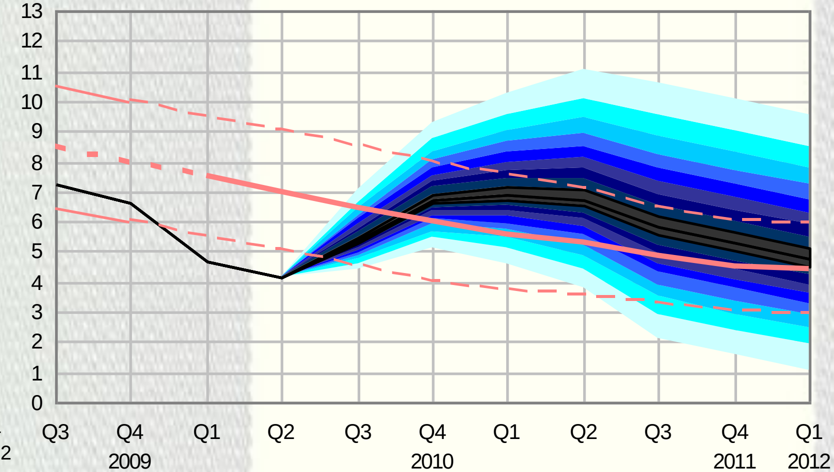
Current vs. previous projection

Chart 28. **Current vs. previous projection**

May projection
(y-o-y rates, %)



August projection
(y-o-y rates, %)



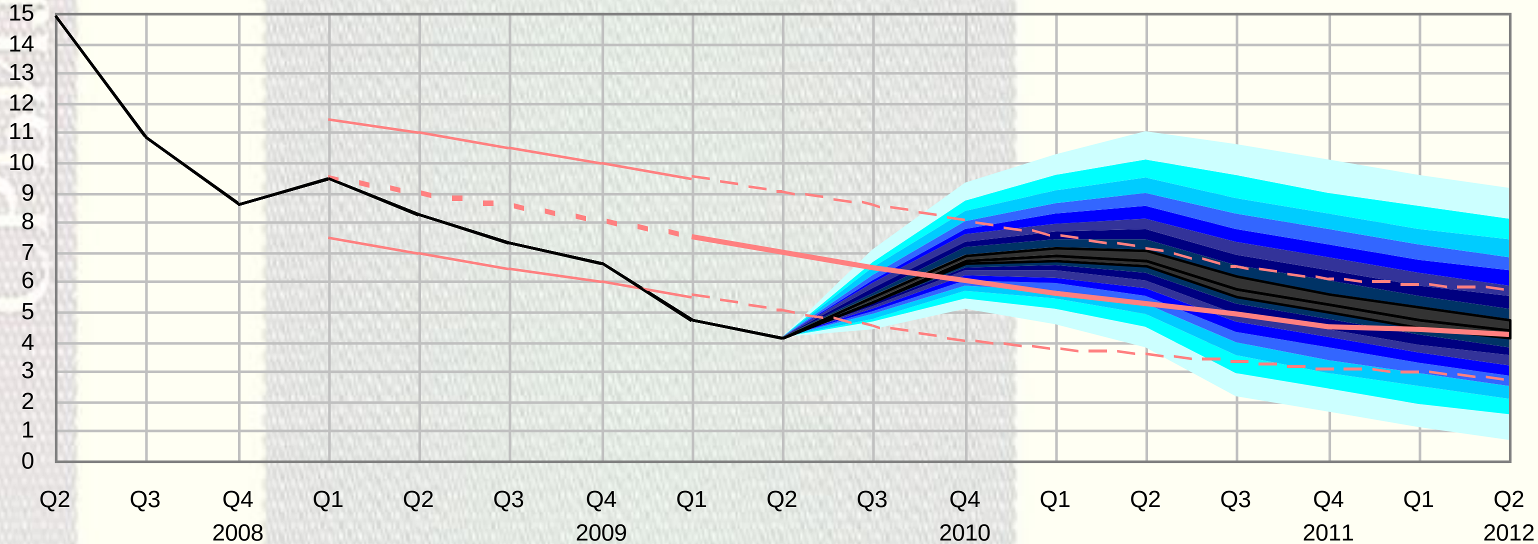
- The August inflation projection is higher than the one published in the May *Inflation Report*. This is due to rising food prices, unexpected rise in risk premium and the resulting build-up in depreciation pressures since May.
- The risks to the current projection are more tilted to the upside and relate to the expected growth in food prices, growing risk premium, the pass-through of dinar's depreciation to prices and the premature lifting of the public wage freeze.
- The current projection was prepared by end-July.

Outlook for the key policy rate

- The Executive Board raised the key policy rate to 8.5% in view of the following:
  - Some of the risks referred to in the May *Inflation Report* have in the meantime materialised - these risks are associated with the influence of weaker agricultural performance on growth in food prices in domestic and international markets, as well as with the impact of higher risk premium on import prices;
  - A hike in primary agricultural product prices (mainly wheat and corn) is likely to exert pressure on a number of processed food products;
  - The pace of economic recovery suggests that the disinflationary effect of aggregate demand will probably weaken, especially in light of lifting of the freeze on public sector wages and pensions announced for April 2011.
- Should inflationary pressures accelerate, a further hike in the key policy rate remains a possibility.
- This will largely depend on future movements in agricultural prices and risk premium.

Inflation projection

Chart 29. **Inflation projection**
(y-o-y rates, %)



- Inflation measured 4.2% in June 2010 and is estimated to have reached around 5% y-o-y in July.
- Y-o-y inflation will return within the target tolerance band in early Q3.
- In mid-2011 it is expected to revolve around the upper bound of the target tolerance band, gradually falling back towards the target, which for end-2011 is set at 4.5   1.5% and for end-2012 at 4   1.5%.

THANK YOU FOR YOUR ATTENTION!