



NATIONAL BANK OF SERBIA

Speech at the presentation of the Inflation Report  
August 2013

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Belgrade, 14 August 2013

*Ladies and gentlemen, esteemed members of the press and fellow economists,*

It is a pleasure for me to present the August *Inflation Report* of the National Bank of Serbia and our view of current economic developments and their outlook in the period ahead.

Inflationary pressures have weakened further since we last met in May, and economic activity indicators seem to suggest ever more clearly that the recovery begun in the last quarter of 2012 is taking hold.

As we have already announced, we expect year-on-year inflation to fall back within the target tolerance band by October and to stay within the band thereafter. You will notice that our new inflation projection is almost the same as the one released in May.

The new projection of GDP growth in 2013 also remains unchanged at around 2.0%. The projection of GDP growth in 2014, however, has been revised down from 3.0% to around 2.5% as the growth prospects for Serbia's main foreign trade partners deteriorated in the meantime. Still, the expected growth of our economy remains above the average of its South East European peers. The economic recovery is undeniably slower than we would all like it to be, but given the intensity and the scale of the crisis, it is quite clear that the recovery cannot be swift and without difficulties. The good news is that it is becoming increasingly evident that the domestic economic activity is on the path of sustainable growth and that external imbalance is narrowing.

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

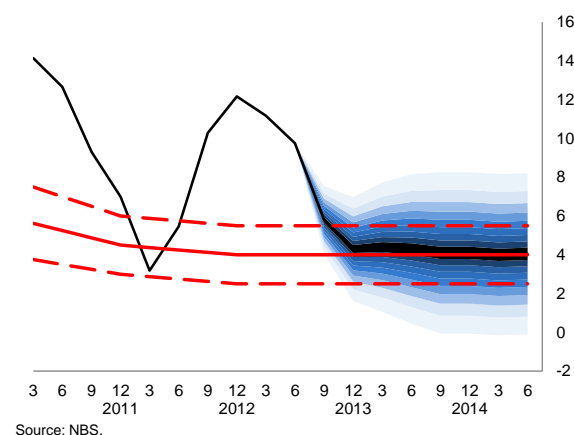
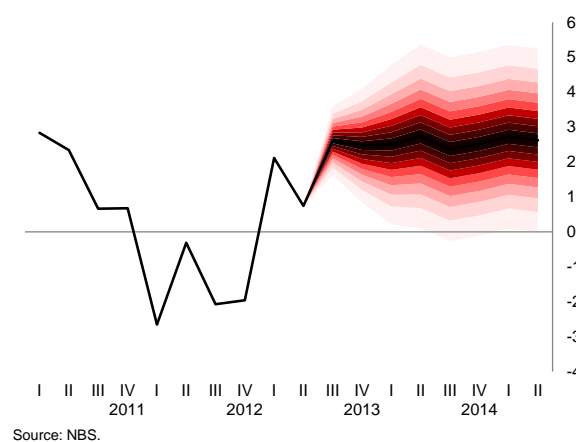


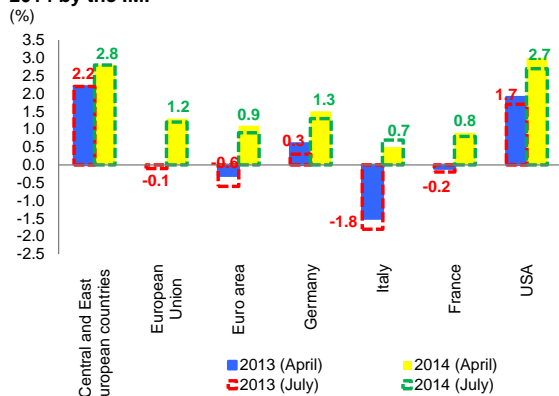
Chart 2 **GDP growth projection**  
(y-o-y rates, in %)



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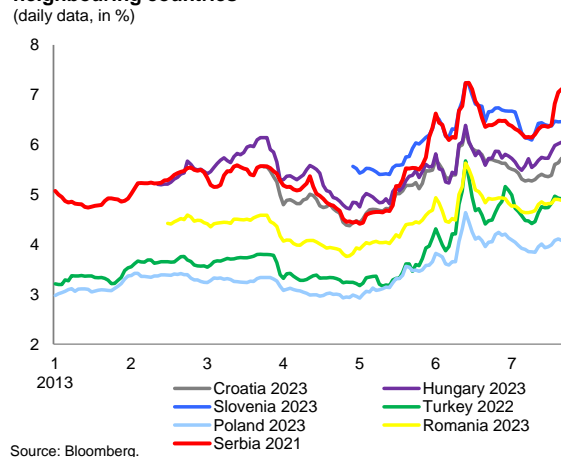
Growth projections for the euro area have been revised down – according to the European Central Bank, the International Monetary Fund and Consensus Forecast, the euro area economy will contract by 0.6% in 2013. Still, an improvement in the early economic activity indicators in the last two months heralds an end to the recession. Particularly encouraging is the slowing pace of contraction of highly-indebted euro area members.

Chart 3 Revisions of real GDP growth forecasts for 2013 and 2014 by the IMF\*



\* Revision relative to the April WEO.  
Source: IMF WEO (April 2013) and IMF WEO Update (July 2013).

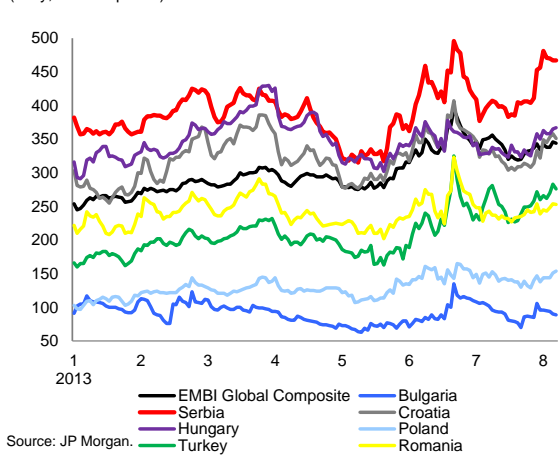
Chart 4 Yield on government bonds in neighbouring countries



Source: Bloomberg.

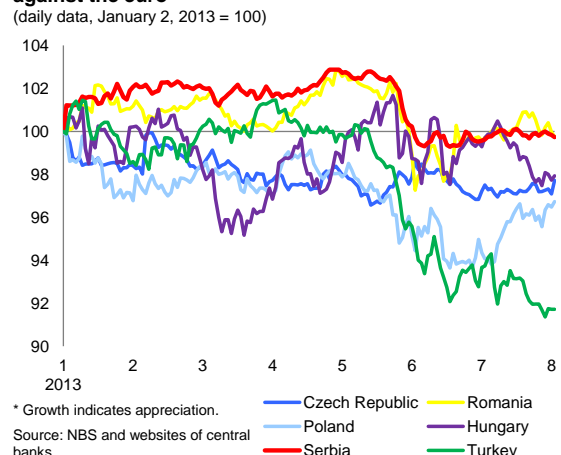
The ECB reduced its main refinancing rate in May to the historical low of 0.5%. The Fed, by contrast, suggested that it might taper its quantitative easing through 2013 and wind it down altogether around mid-2014 if economic growth becomes firm enough. The Fed's hint gave rise to instability in the international financial markets as investors reacted by reducing their exposure towards riskier markets. The yields on sovereign bonds rose, country risk premiums increased and the currencies of nearly all countries in the region depreciated. In the case of Serbia, this effect was further amplified by the IMF's statement on the necessity of taking additional fiscal consolidation measures. Similarly to other central banks, the NBS intervened during this period by selling foreign exchange in the foreign exchange market.

Chart 5 Risk premium indicator – EMBI by country



Source: JP Morgan.

Chart 6 Movements in exchange rates of national currencies against the euro\*



\* Growth indicates appreciation.  
Source: NBS and websites of central banks.

The situation in the international financial markets gradually eased in the course of July. EMBI for Serbia fell from the June high and the dinar edged up slightly against the euro. Besides, Fitch affirmed Serbia's credit rating, ending speculations of a possible downgrade which emerged after Moody's assigned to Serbia a comparatively one notch lower rating.

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External imbalance narrowed in 2013 faster than we expected – in the first six months, the current account deficit was by 53.5% lower compared to the same period last year, and equalled 5.7% of estimated GDP. Rather more important is the fact that a reduction in the current account deficit originates primarily from the significant increase in exports relative to imports (20% vs. 2% year-on-year). Positive changes in terms of narrowing of external imbalance are also corroborated by increased exports not only in the motor vehicles category, but also in other sectors (the chemical industry, production of rubber and plastic products, electrical equipment etc).

Chart 7 Exports and imports of goods and services  
(in constant prices 2010)

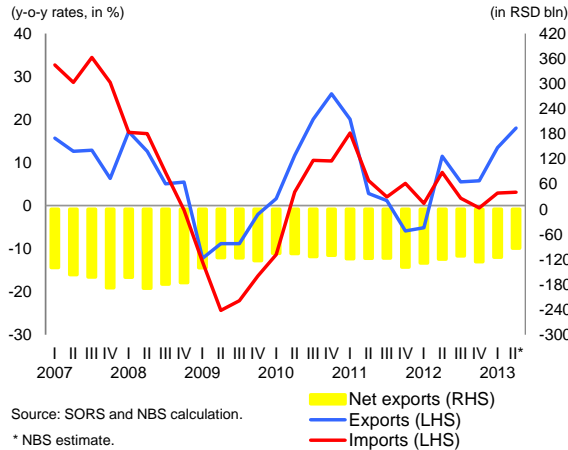
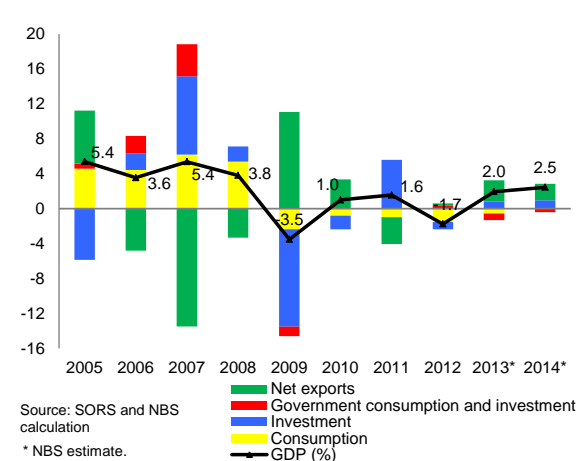


Chart 8 Contributions to y-o-y GDP growth\*  
(in pp)



The start-up of investments primarily in automobile and oil industries, and fiscal consolidation, are expected to bring down the share of the current account deficit in GDP from 10.5% in 2012 to below 7.0% this year. This share should continue to decline over the coming years.

GDP growth in 2013 and 2014 will be led mainly by rising net exports and to a lesser extent by private investments. According to our estimate, private consumption will decline this year because of lower real income and sluggish growth in lending activity, while the contraction in government consumption will be due to the implementation of fiscal consolidation measures. The deviation from the projection is equally possible in either direction and depends primarily on the speed of economic recovery of Serbia's main foreign trade partners and the outcome of this year's agricultural season.

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Year-on-year inflation moved in Q2 in accordance with expectations presented in the *May Inflation Report*. Inflation continued down and reached 8.6% in July. However, the year-on-year inflation rate still remains relatively high, but this is due mainly to price growth recorded from August to October 2012. Of the mentioned 8.6%, as much as 6.9 percentage points relates to price growth in that period. In other words, the average monthly inflation rate from November last year to July this year was 0.2%.

Inflation declined as a result of past restrictive monetary policy measures, a reduction in raw material costs in food production, low aggregate demand and relative stability of the exchange rate.

According to our estimates, with the exclusion of high last year's price growth from calculation, year-on-year inflation will accelerate down in the third quarter.

Chart 9 Contribution of CPI components to y-o-y inflation (in pp)

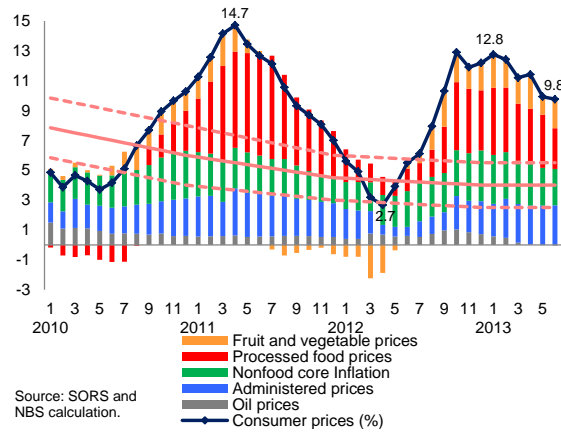
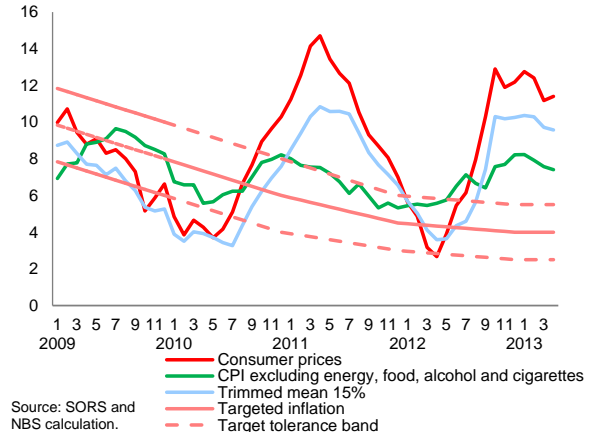


Chart 10 Price movements (y-o-y growth, in %)



The key disinflationary factor in the coming period will be lower food production costs, expected mainly on account of a further reduction in prices of primary agricultural commodities. It is quite certain already that this year's agricultural season will be much better than the last one both at home and abroad. In view of this, raw material costs in domestic food production are expected to be lower at least until the next agricultural season, and so are the rates of food inflation.

On the other hand, administered prices will rise this year by around 10% and will contribute 2.0 percentage points to inflation, mainly because of the electricity price increase. As we have emphasised several times already, this will not jeopardise the return of inflation within the target tolerance band. Also, the weakening of the dinar in late May and in June may send upward pressure on import prices, but the intensity of this pressure will depend on the importers' ability to increase prices against the backdrop of depressed demand.

Given all of the above, we expect that inflation will return within the target tolerance band by October and stay within the band thereafter. Let us recall, the National Bank of Serbia's inflation target is  $4 \pm 1.5\%$ .

Chart 11 Prices of primary agricultural commodities and their futures (USD/t)

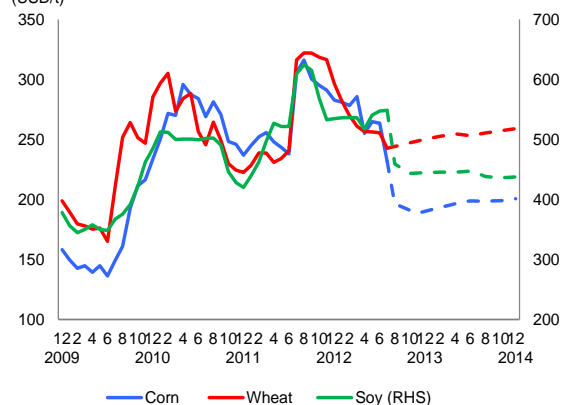
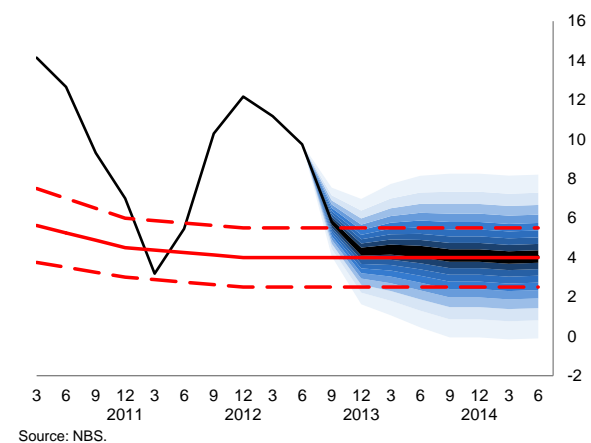


Chart 12 Inflation projection (y-o-y rates, in %)



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Guided by the analysis of current and expected macroeconomic developments, the Executive Board of the National Bank of Serbia decided last week to keep the key policy rate at 11.0%.

Assuming agricultural commodity prices decline further, no external shocks occur and fiscal consolidation is implemented as planned, the Executive Board will consider further monetary policy easing in the coming period.

It is indisputable that our economy is slowly recovering. However, in order to ensure sustainable economic growth and keep inflation within the target tolerance band, additional efforts are needed towards a further reduction in internal and external imbalances. An important step to this effect is the adoption of the revised budget and new measures of structural adjustment, which is why the National Bank of Serbia supports the Government's commitment to implementing the announced measures. Consistent implementation of these measures would improve investor perception of Serbia and create the leeway for further monetary policy easing.